NEW ISSUES AND NEW TWISTS ON OLD ISSUES (BUSINESS INCOME TAXATION IN TODAY'S WORLD – MAY THE TREND BE YOUR FRIEND)

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California Bank and Corporation Tax Revenues
1988 - 1998

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Introduction

Bank and Corporation Tax revenues are the third largest source of revenue for the State of California. In recent years, these revenues have not kept pace with either the growth of the California economy in general, or with the growth of other major sources of California revenue. As reported in Table 1, California Gross State Product (GSP) grew by 63 percent between 1988 and 1998.[1] The two largest sources of California revenue, the Personal Income Tax and the Sales and Use Tax, reflected this growth. Personal Income taxes grew 102 percent between 1988 and 1998, and Sales and Use taxes increased by 68 percent. Bank and Corporation taxes, by contrast, increased by only 18 percent during this period. After adjusting for inflation, real Bank and Corporation Tax revenues actually decreased by 14 percent during this time period. The goal of this paper is to describe, and to evaluate the relative importance of, several factors contributing to the weakness of California Bank and Corporation Tax revenues.

In attempting to locate the sources of weakness in Bank and Corporation revenues, this paper begins by surveying trends in the national economy and in federal corporate tax law. It then examines several state-specific factors affecting corporate tax revenue growth. Where possible to quantify, the revenue impact of specific factors is reported. Factors found to have contributed substantially to the weakness in Bank and Corporate Tax revenues include: recognition by California of the S-corporation structure, an increase in corporate tax credits, a reduction in California corporate tax rates, the allowance by California of net operating loss carryforwards, and adoption by California of elective water's-edge filing.

1. The relationship between economic growth and corporate tax revenues at the federal level.

The level of corporate profits nationally

[1] We choose 1988 as the base year for this analysis because analysis of the immediately preceding years is complicated by the major federal tax reform of 1986 and subsequent California conformity legislation.

It is possible that structural changes in the economy unrelated to tax law are reducing the relative importance of corporate profits in the economy. There are at least two ways in which such a structural change could occur. One is that sectors of the economy in which corporations are relatively important may be growing more slowly than sectors in which corporations are relatively less important. For example, if it were the case that all manufacturing were done by corporations while all services were performed by partnerships, then a shift in the composition of the economy from manufacturing to services would reduce corporate profits' share of the economy. The second possible structural change in the economy is a reorganization of business entities that does not affect production. For example, if a large number of corporations opted to reorganize themselves as Limited Liability Companies (LLCs), this would reduce corporate profits' share of the economy. A number of recent legislative changes, particularly in the area of LLCs, may have encouraged businesses to operate in a noncorporate form. If corporate production as a percentage of economic activity is decreasing, we would expect corporate taxes as a percentage of economic activity to decline also.

Empirically, however, the ratio of corporate profits to economic output (at the federal level) actually increased from 1988 to 1998. Economic output, as measured by Gross Domestic Product (GDP), grew 71 percent during this time period.[2] One popular measure of corporate profits, Corporate Profits with Inventory Valuation and Capital Consumption Adjustments from the National Income Product Accounts (NIPA), grew 110 percent over this period. Another common measure of corporate profits, Corporate Receipts Less Deductions from the IRS's Statistics of Income (SOI), grew 106 percent from 1988 to 1998. Chart 1 presents the ratio of SOI's Corporate Receipts Less Deductions to GDP. Chart 1 reflects the often cyclical nature of corporate profits. The ratio of corporate profits to GDP dropped 28 percent from 1988 to 1991, then rose 87 percent from 1991 to 1997. The ratio dropped slightly in 1998. Since corporate profits grew faster than the general economy over the 10-year period, weakness in corporate profitability cannot explain the weakness of Bank and Corporation Tax revenues.

A note on tax shelters

It has been suggested by various commentators that there has been an upsurge in recent years in tax shelter activity.[3] If true, this would also reduce the level of profits reported from corporate activities and, in turn, reduce corporate tax revenues. Conceptually, tax shelter activity should affect the relationship between corporate profits and taxable corporate profits. However, in practice, tax shelter activity will instead reduce the measured level of corporate profits.[4] This is because all of the data series on corporate profits are constructed from tax return data. The NIPA data make a number of adjustments to the tax return data in an attempt to measure "economic profit"; but the major adjustments, such as those for accelerated depreciation and the effects of inflation on inventory valuation, are not related to tax shelter activity. NIPA includes an adjustment for underreporting of income on tax returns, but this measure is based on historical audit experience and, therefore, is of little use in assessing recent changes in tax shelter activity. Therefore, the data in this paper cannot shed any light on the tax shelter debate.

Federal taxable corporate profits

There are several types of corporations whose profits are not taxable at the federal level. These include Regulated Investment Corporations (RICs), Real Estate Investment Trusts (REITs) and S-corporations. Both RICs and S-Corporations have grown substantially in importance during the 1990s.

RICs (mutual funds) and REITs are not taxed at the corporate level by either the federal or the California government. We would, therefore, expect corporate tax revenues not to keep pace with corporate profits if these sectors are responsible for the growth of corporate profits. Removing RICs and REITs from SOI Total Receipts Less Deductions lowers the growth rate for

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[2] Note that the 71 percent increase in GDP nationally is slightly greater than the 64 percent growth in California GSP over the same period.

[3] See, for example, Joseph Bankman, *The New Market in Corporate Tax Shelters*, **Tax Notes**, June 21, 1999 p. 1775-1795, or Michael M. Phillips, *Taking Shelter, As Congress Ponders New Tax Breaks, Firms Already Find Plenty*, **Wall Street Journal**, August 4, 1999, p. 1.

[4] This point was made by James B. Mackie III, *The Puzzling Comeback of the Corporate Income Tax*, Proceedings of the 92nd Conference on Taxation, National Tax Journal, Washington, DC, 2000.

this series to 91 percent for the 1988 – 1998 period. This still exceeds the growth of GDP during these years.

The S-corporation was first introduced in 1958. At the federal level, S-corporations are taxed exclusively as pass-through entities; thus, they are not taxed at the corporate level at all. In California, S-corporations are taxed at the corporate level, but at a much lower rate than C-corporations. Several changes in the Tax Reform Act of 1986, including the repeal of the General Utilities Doctrine, spurred a rapid growth in the number of S-corporations. At the federal level, the number of S-corporations increased from 0.8 million in 1986 to more than 2.1 million in 1995. The expansion of the S-corporation sector reduces the percentage of corporate profits that are taxable at the federal level.

Federal corporate income subject to tax (taken from SOI) grew 73 percent between 1988 and 1998. This is substantially less than the growth in either NIPA corporate profits or SOI Receipts Less Deductions during this time period. At the federal level, therefore, the exemption of certain corporate profits from the tax base has grown faster than corporate profits in general.

The relationship between income subject to tax and liability at the federal level

Changes in the relationship between income subject to tax and liability at the federal level are primarily due to statutory changes, such as federal tax rates and federal treatment of net operating losses, that should not affect California revenues. Nonetheless, it is interesting to compare the relative growth of federal and state tax liabilities. Federal corporate tax liability before credits increased 74 percent between 1988 and 1998. This means that federal corporate tax revenue grew at almost exactly the same rate as corporate income subject to tax (73 percent) during this period.

2. The relationship between national corporate profits and California corporate State Net Income

Corporate profits are not the same for federal and state tax purposes. Chart 2 presents the ratio of California State Net Income (SNI) to SOI Receipts Less Deductions from 1988 to 1998. This ratio fell from 8.4 percent in 1989 to 3.9 percent in 1992, reflecting the fact that the recession at the beginning of the 1990s was deeper and longer lasting in California than in the rest of the country. This ratio rebounded in 1994 and remained stable at around 6 percent through 1998.[5] Overall, from 1988 to 1998, SNI increased 56 percent. This is substantially less than the 106 percent growth in SOI federal corporate profits and slightly lower than the 63 percent growth in California gross state product during this time period, so SNI weakness is a significant contributor to the recent weakness in California Bank and Corporation Tax revenues. The 56 percent growth in SNI is still substantially greater than the 18 percent growth in Bank and Corporation revenues, however, so federal – state differences in the measurement of corporate income cannot, by themselves, explain the weakness in Bank and Corporation revenues. The remainder of this section will discuss a number of issues that may bear on the relationship between corporate profits for federal and state purposes.

Regional differences in economic activity

In addition to statutory differences in the definition of income, the relationship between SNI and federal net income will reflect differences in economic performance between California and the rest of the nation. Federal net income numbers include three types of firms: firms not conducting business in California, firms conducting some but not all of their business in California, and firms conducting business exclusively in California. California taxes none of the income from the first group, some of the income from the second, and all of the income from the third. Changes in the ratio of SNI to federal income may, therefore, reflect either changes in the relative importance of these three groups, or changes in the proportion of the income (known as apportionment factors) from the second group.

Chart 3 presents the ratio of net income for corporations taxable in California (before state adjustments and apportionment) to total federal corporate profits. The rise in this ratio in

[5] It is interesting to note that the ratio of state to federal corporate profits (at about 6 percent) is less then

1989 and 1990 suggests that California did not fall into the last recession as soon as did the rest of the country. This ratio bottomed out in 1992, when California was more deeply in recession than the rest of the country. From 1994 to 1997 this ratio was relatively stable. In 1998, the ratio jumped up again.[6] Overall, this ratio increased from 1988 to 1998, suggesting that general weakness of the California economy relative to the national economy has not played a major role in the weakness of Bank and Corporation revenues. The sensitivity of this analysis to the exact choice of end point years, however, suggests that we should be cautious in assigning a firm quantitative weight to this factor.

State adjustments to income

Differences in corporate profits for state and federal purposes can be classified as resulting either from statutory differences in which profits are taxable or from differences in economic activity in different jurisdictions. Statutory differences arise from the fact that California has elected not to conform to the federal definition of income in several important areas. For example, differences in federal and state treatments of depreciation generate additions to income. On the other side, a number of types of dividends and certain capital gains may be subtracted from income under state law.

Another potentially important recent change that may be reducing the ratio of state to federal net corporate income is the adoption by California of “water’s-edge” elections for tax years beginning on or after January 1, 1988. Previously, California considered total worldwide net income for all corporations. When corporations report on a worldwide basis, they begin with their federal profits, which are water’s-edge in nature. They then adjust these numbers to achieve worldwide income for California purposes. If the firms electing water’s-edge have profitable worldwide operations (which they should), then their reported adjustments should decrease upon election. While water’s edge was adopted prior to 1988, the policy was relatively new, and the number of corporations opting for water’s edge was increasing rapidly during the years in

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half of the ratio of state GSP to federal GDP (almost 13 percent).

[6] This jump in 1998 may be related to the drop in apportionment factors in the same year discussed below (see footnote 12). If so, it is unimportant to our analysis of revenue trends.

question. The number of water's edge electors increased from 406 in 1988 to 1,130 in 1989 to 2,191 by 1992. The expected reduction in net income reported by companies electing water's-edge treatment will be partially offset by a corresponding increase in apportionment factors.[7] Firms will be more likely to elect water's edge, however, if doing so will reduce their tax liability. We estimate the 1998 revenue loss from allowing water's edge elections to be approximately $350 million.

It is possible that nonconformity between federal and state law has been growing in importance and may account for the weakness in California corporate revenues. Chart 4 presents the ratio of net corporate income for California purposes after and before state adjustments for the years 1988 – 1998. The ratio of income after state adjustments to income before state adjustments decreased from 1988 to 1992 then rebounded to just below the 1988 level. It thus appears that differences in adjustments from federal to state income have contributed slightly to the weakness in Bank and Corporation revenues.

Apportionment issues

As noted above, California does not tax all income of corporations conducting business in California. Rather it taxes only the portion of this income attributable to business activity taking place in California. This portion is determined by applying apportionment factors to a corporation's income. Several factors may have reduced average apportionment factors over the last decade and, in turn, contributed to the weakness in California corporate tax revenues. First, California emerged from the recession of the early 1990s later and more slowly than the rest of the United States. California Personal Income increased 64 percent between 1988 and 1998, less than the 73 percent growth in personal income at the national level. The proportion of national business activity attributed to California should, therefore, decrease somewhat.

[7] Apportionment factors measure the percentage of a corporation's business attributable to California. Corporations electing water's-edge will switch from using factors measuring the ratio of business conducted in California to business conducted worldwide to factors measuring the ratio of business conducted in California to business conducted in the United States. Since worldwide property, payroll, and sales must be greater than US property, payroll, and sales, the latter ratio must be greater than the first ratio. Thus, water's-edge election should raise apportionment factors.

A related consideration offered by some commentators is that there may have been an upswing recently in the resources devoted by corporations to state tax planning.[8] One area in which this trend may manifest itself is in organizing business operations to minimize apportionment factors in states that tax corporate income.

The aggregate ratio of post-apportionment to pre-apportionment income may also have shifted because of changes in the apportionment formula. California adopted a "double weighted sales factor" for most corporations in 1993.[9,10] An analysis of corporate tax return data suggests, however, that the revenue effect of this change was not significant.

Chart 5 presents the ratio of net corporate income after state adjustments but before apportionment to State Net Income (SNI) after apportionment for the years 1988-1998. The ratio of SNI to pre-apportionment income dropped from 13.7 percent in 1988 to less than 7.6 percent in 1993. It then rebounded to 10.9 percent in 1994, and remained between 10.8 and 11.8 percent through 1997. In 1998, the ratio dropped to 8.8 percent.[11] Comparing 1988 to 1998, State Net Income increased by 56 percent, compared to a 142 percent increase in pre-apportionment income. If, instead, we compare 1989 to 1998, pre-apportionment income increased 63.4 percent, compared to 63.5 percent growth in post-apportionment income. The sensitivity of the analysis to the choice of the initial year makes it difficult to assess the impact of changes in apportionment factors on the weakness of Bank and Corporation revenues.

[8] See, for example, Richard D. Pomp, *The Future of the State Corporate Income Tax: Reflections (and Confessions) of a Tax Lawyer*, **State Tax Notes**, March 22, 1999, p. 939-948.
[9] Agriculture and extractive industries were specifically exempted from this change.
[10] Previously, California used an equally weighted three-factor formula in which the portion of income attributed to California was equal to [(CA sales / total sales) + (CA payroll / total payroll) + (CA property / total property)] / 3. The new factor is equal to [2 * (CA sales / total sales) + (CA payroll / total payroll) + (CA property / total property)] / 4. For corporations whose sales factor is smaller than the other two factors, double-weighting the sales factor lowers the composite apportionment factor and lowers the ratio of State Net Income to pre-apportionment income. For corporations whose sales factor is larger than the other two, the effect is reversed.
[11] As noted above, the drop in this ratio in 1988 may be offsetting the increase in the ratio of state income before adjustments and apportionment to federal profits in the same year. The likely cause of this is merger activity in which corporations not previously doing business in California merge with California corporations. When this happens, all of the income of the non-California corporation gets added to SNI before apportionment, increasing the ratio of SNI before apportionment to federal corporate income. At the same time, the non-California corporation's property, payroll, and sales are added to the denominator, but not to the numerator, of the combined company's apportionment factors. This reduces the ratio of SNI to pre-apportionment SNI. This would explain the 1998 data reported in Charts 3 and 5, but these two effects

3. The relationship between State Net Income and corporate tax revenues.

Net vs. positive SNI

From 1988-1998, California Bank and Corporation Tax liabilities grew only 18 percent, despite the 56 percent growth in State Net Income. As can be seen in Chart 6, tax liability does not vary with the business cycle as much as State Net Income does. Liabilities dropped much more slowly than income from 1989 to 1992, and grew much more slowly than income from 1992 to 1997. This cyclical pattern arises from the fact that corporations with net losses can experience huge swings in the size of these losses without altering their tax liability. In recession, companies already losing money tend to lose even more money, reducing aggregate SNI, but do not owe any less tax. When companies turn profitable during a recovery, any further increase in profits is taxed at the corporate tax rate – a rate that is higher than the average tax rate levied on aggregate SNI (which includes losses). One method of controlling for this problem is to separate net SNI into SNI for profitable corporations and SNI for loss corporations.

SNI growth for corporations with positive income was 70 percent between 1988 and 1998, slightly higher than the 56 percent to SNI growth for all corporations. This is due to a surprising 26 percent increase in the losses of money losing corporations in 1998.[12] From 1988 to 1997, SNI for all corporations increased 67 percent, compared to a 61 percent increase in SNI for corporations with positive income. This variation makes it difficult to assess the effects of cyclicality on the weakness of Bank and Corporation revenues.

As shown in Chart 7, positive SNI and tax liability tracked quite closely from 1988 until 1993. Since 1993, however, the growth in tax liability has been substantially weaker than the

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should cancel and not affect the overall ratio of SNI to federal corporate profits (Table 2) or Bank and Corporation Tax revenues.

[12] We do not have any solid evidence as to why SNI dropped in 1998 despite a seemingly strong California economy. However, anecdotal evidence suggests a number of possible contributing factors. One is the size of losses posted in 1998 by a substantial number of ".com" companies. Another is the effect of several specific large mergers that took place in 1998. Mergers often generate one-time costs that, while small relative to the involved companies' revenues, may be large relative to their profits.

growth in income of corporations reporting positive profits. The ratio of liabilities to positive corporate SNI dropped from 8.4 percent in 1988 to 5.8 percent in 1998. Several factors contributed to this change.

Taxable Income

One factor is the treatment of losses. Starting in 1987, California allowed corporations to subtract one half of all net operating losses (NOLs) generated in the previous five years from their SNI before calculating their taxes.[13] California also allows corporations to deduct certain losses resulting from natural disasters. Losses allowed California corporations to reduce their taxable income by $5.8 billion in 1998. This reduced Bank and Corporation revenues by about $340 million in 1998. From 1988 to 1998, NOL usage increased 215 percent. As a result, taxable income increased by only 65 percent, compared to the 70 percent increase in positive SNI. An increase in losses to offset income has, therefore, contributed to the sluggishness of Bank and Corporation revenues during this period.

S-corporations

Another important factor is the recognition by California of the S-corporation. California first allowed S-corporations in 1987. The number of S-corporations in California has grown from 50,964 in 1988 to 143,178 in 1998. As a result, by 1998 approximately 31 percent of all corporations paying taxes in California were S-corporations. S-corporations are taxed at a rate of 1.5 percent, compared to the 8.84 percent rate for C-corporations. Therefore, the shift of businesses to S-corporation status has reduced the ratio of tax liability to SNI for California corporations. The exact revenue impact of S-corporations depends on how many S-corporations would still have chosen to be corporations if the S-corporation option were not available. If all S-corporations had been C-corporations, California corporate tax liabilities would have increased by about $1.7 billion in 1998. Alternatively, if we assume that all S-corporations that had once been C-corporations had remained C-corporations in 1998, but that all other S-corporations would not

[13] The deduction of net operating losses was suspended for tax years beginning in 1991 and 1992.

have formed as corporations, 1998 corporate liability would have been just over $1.0 billion greater. We estimate the actual effect of S-corporations on corporate liability to lie closer to the first of these two numbers, at slightly less than $1.6 billion. This makes S-corporations one of the most important sources of weakness in Band and Corporation revenue growth. Of course, since S-corporation income is passed through to shareholders, their personal income tax implications must also be considered in calculating the overall revenue impact to the state of S-corporations. We estimate the personal income tax revenue gain from S-corporations to be less than $300 million for 1998, thus the net revenue loss from S-corporations is about $1.3 billion.[14]

Tax rates

A third factor lowering the ratio of liabilities to SNI is the recent reduction in California corporate tax rates. The rate for C-corporations was lowered from 9.3 percent to 8.84 percent in 1997. The rate for S-corporations was reduced from 2.5 percent to 1.5 percent in 1995. Had California collected tax on 1998 income at the 1988 rates, approximately $520 million more would have been collected.

Tax Credits

Finally, there has been a dramatic increase in tax credits granted to California corporations since 1988. In 1988, California corporations claimed only $64 million in tax credits. In 1998, they claimed $949 million in tax credits, an increase of 1,383 percent. The biggest credits claimed in 1998 were $463 million for the research and development credit and $318 million for the manufacturer's investment credit. Chart 8 presents the time trend in the ratio of credits to corporate tax liabilities. This ratio increased from 1.5 percent in 1988 to 18.9 percent in 1998. As a result, Bank and Corporation liabilities increased only 18 percent during this time period, compared to a 38 percent increase in Tax Before Credits.

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[14] The net gain from S-corporations on the PIT side is smaller than the Bank and Corporation loss primarily because flow-through losses may be used to offset other types of income and, hence, are more likely to reduce taxes than are losses that must be taken at the corporate level.

4. Conclusion

California Bank and Corporation Tax liability grew only 18 percent from 1988 to 1998. This is substantially less than the contemporaneous growth in other major sources of California revenue and in the California economy in general during this time period. A variety of factors contributing to the sluggishness of Bank and Corporation revenue have been discussed above. Table 2 summarizes the revenue impact of the five important recent changes that we have been able to estimate: tax credits, tax rate changes, S-corporations, water's-edge elections, and carryover losses. The table compares actual growth in Bank and Corporation revenues to the growth that would have occurred in the absence of any one of these changes (keeping the other four changes). It also reports the estimated revenue growth in the absence of all five factors.[15] We estimate that together these five changes would have resulted in a revenue increase from 1988 to 1998 of 104 percent. While still slightly smaller than the growth in corporate profits at the national level, this would have exceeded both the growth of the California economy and the growth of California's other major sources of revenue during these years.

[15] Note that the cumulative impact of two changes in tax law may not equal the sum of the isolated impact of each change. For example, if we revert to 1988 tax rates, the tax on S-corporations will increase by 1 percent of positive SNI (1.5 percent to 2.5 percent); however, if we first disallow S-corporations, the effect on of a rate change on these corporations will only be 0.46 percent of positive SNI (8.84 percent to 9.3 percent).

Califonia Bank and Corporation Tax Revenues 1988 - 1998

Table 1 Growth of California Gross State Product and Major Revenue Sources 1988 - 1998	
	Growth
Gross State Product	63%
Personal Income Taxes	102%
Sales and Use Taxes	68%
Bank and Corporation Taxes	18%

Table 2

Percentage Growth in Bank and Corporation Liabilities 1988 - 1998
Under Various Assumptions

Assumption	Growth
Actual	18%
Eliminate Tax Credits	40%
1988 Tax Rates	30%
Disallow S-corporations	55%
Eliminate Carryover Losses	26%
Disallow Water's-Edge Elections	26%
Cumulative Effect	104%

Chart 1
Ratio of SOI Corporate Receipts Less Deductions to GDP

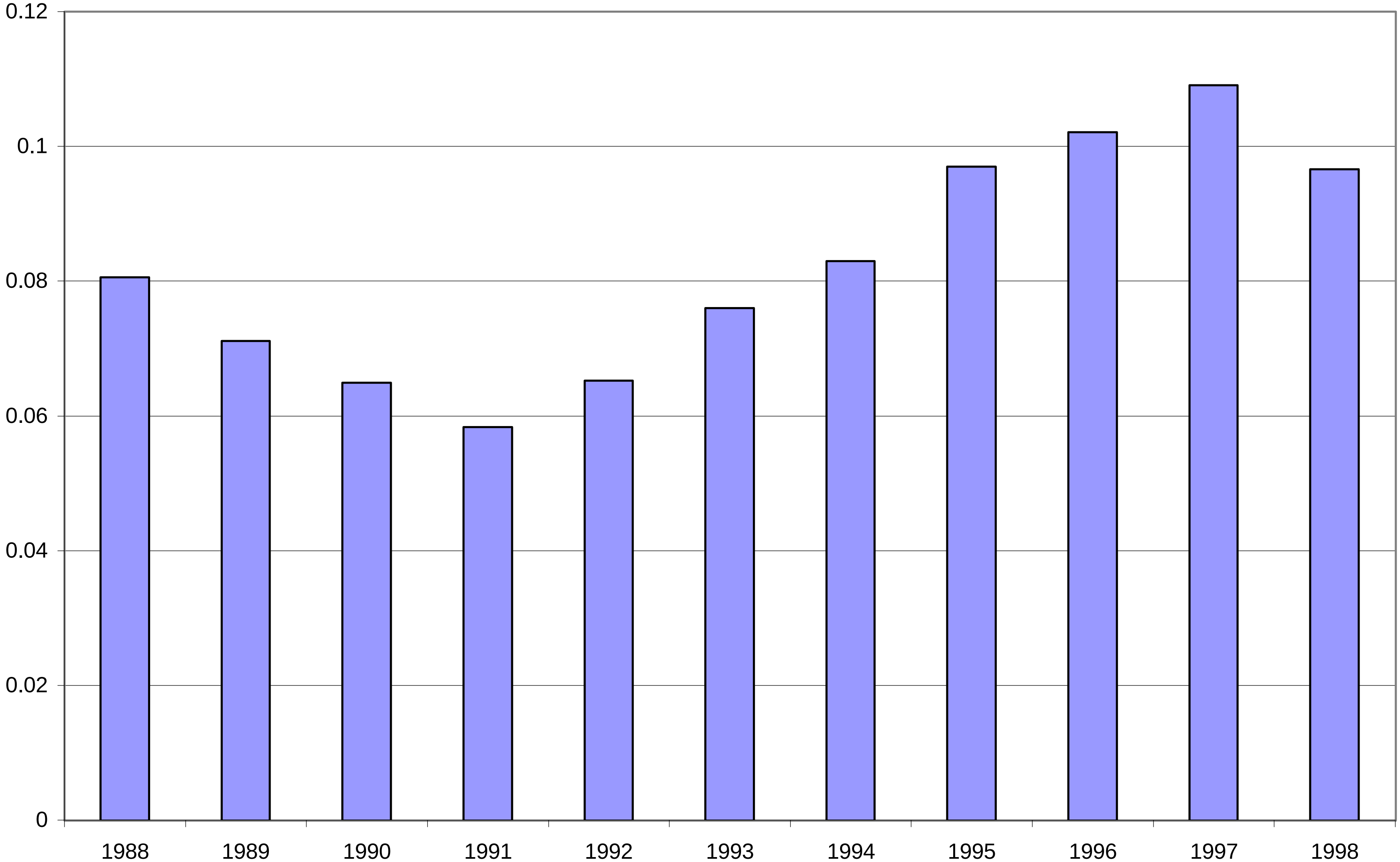


Chart 2
Ratio of State Net Income to SOI Corporate Receipts Less Deductions

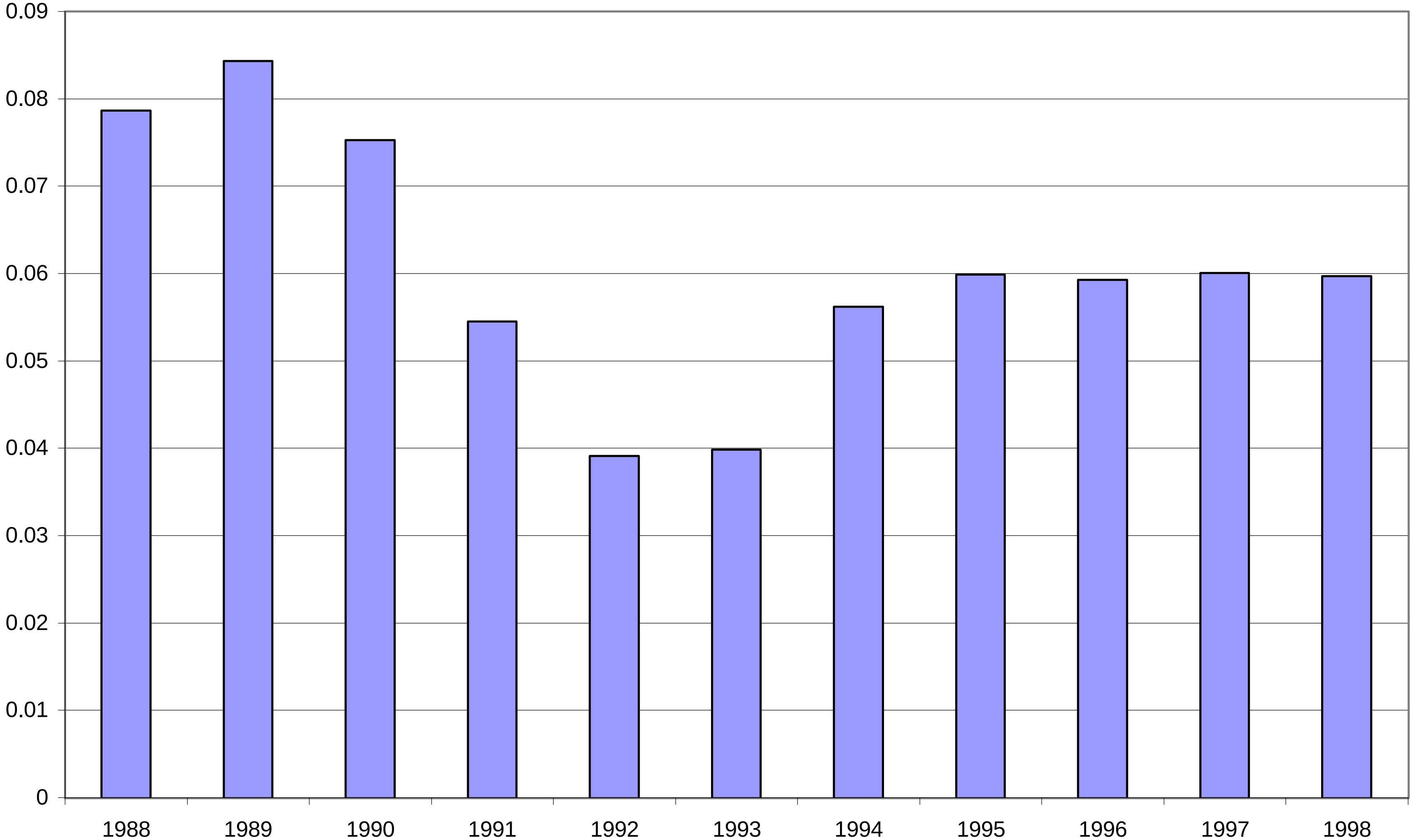


Chart 3
Ratio of Net Income for Corporations Taxable in California, Before State Adjustments and Apportionment, to SOI Corporate Receipts Less Deductions

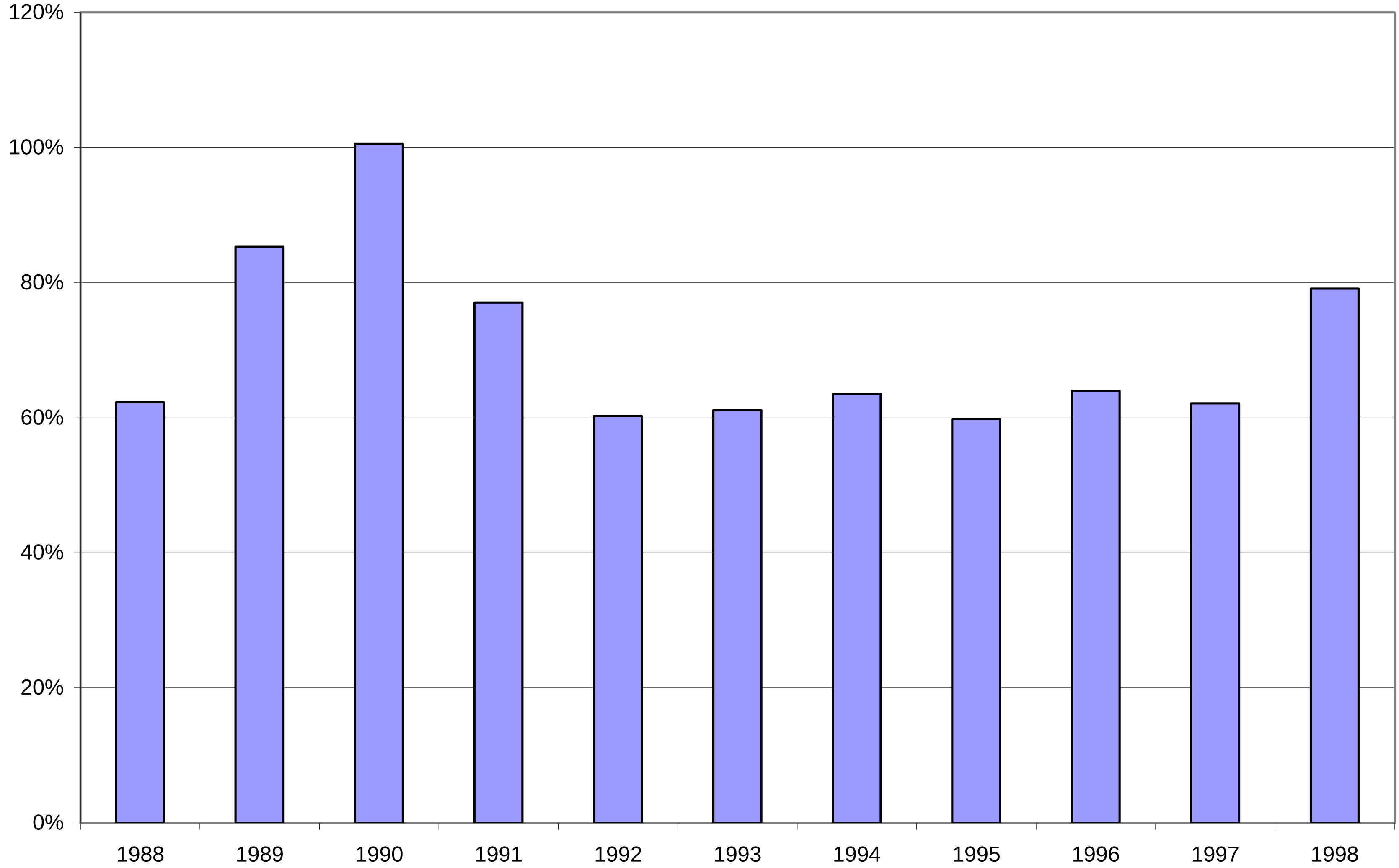


Chart 4
Ratio of California Corporate Net Income After and Before State Adjustments

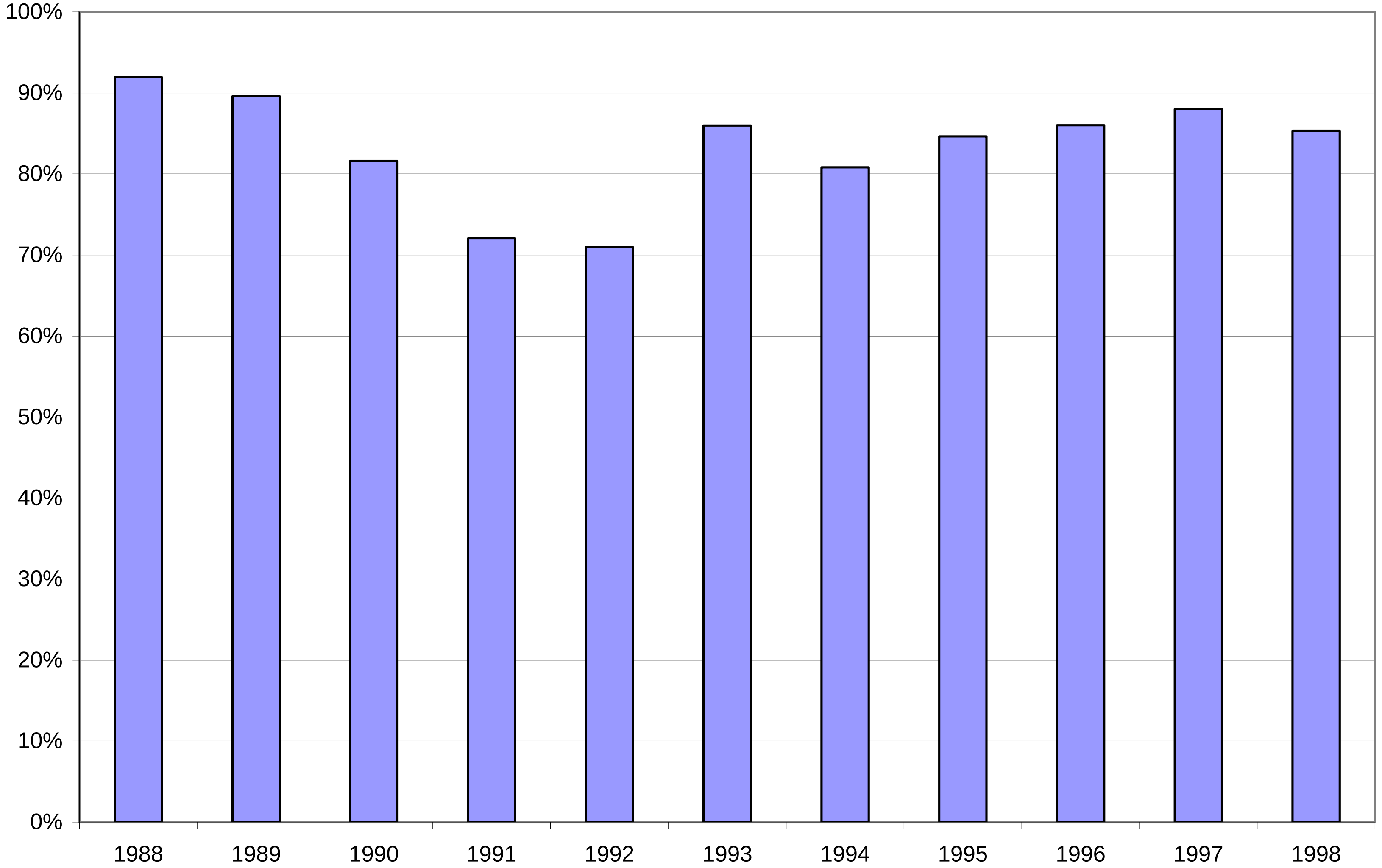


Chart 5
Ratio of State Net Income to Pre-Apportionment Income

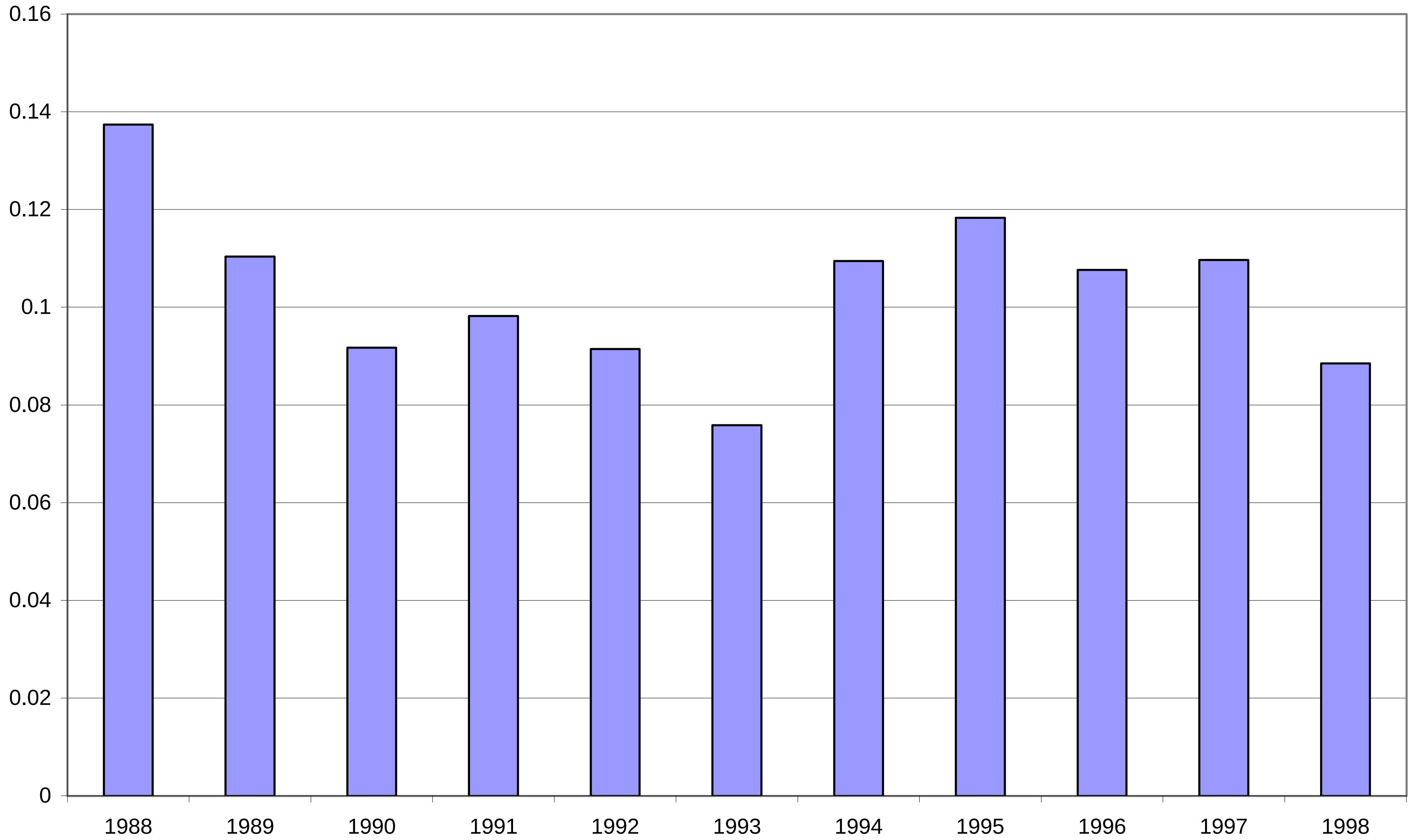


Chart 6
State Net Income and Bank and Corporation Liabilities
($ Billions)

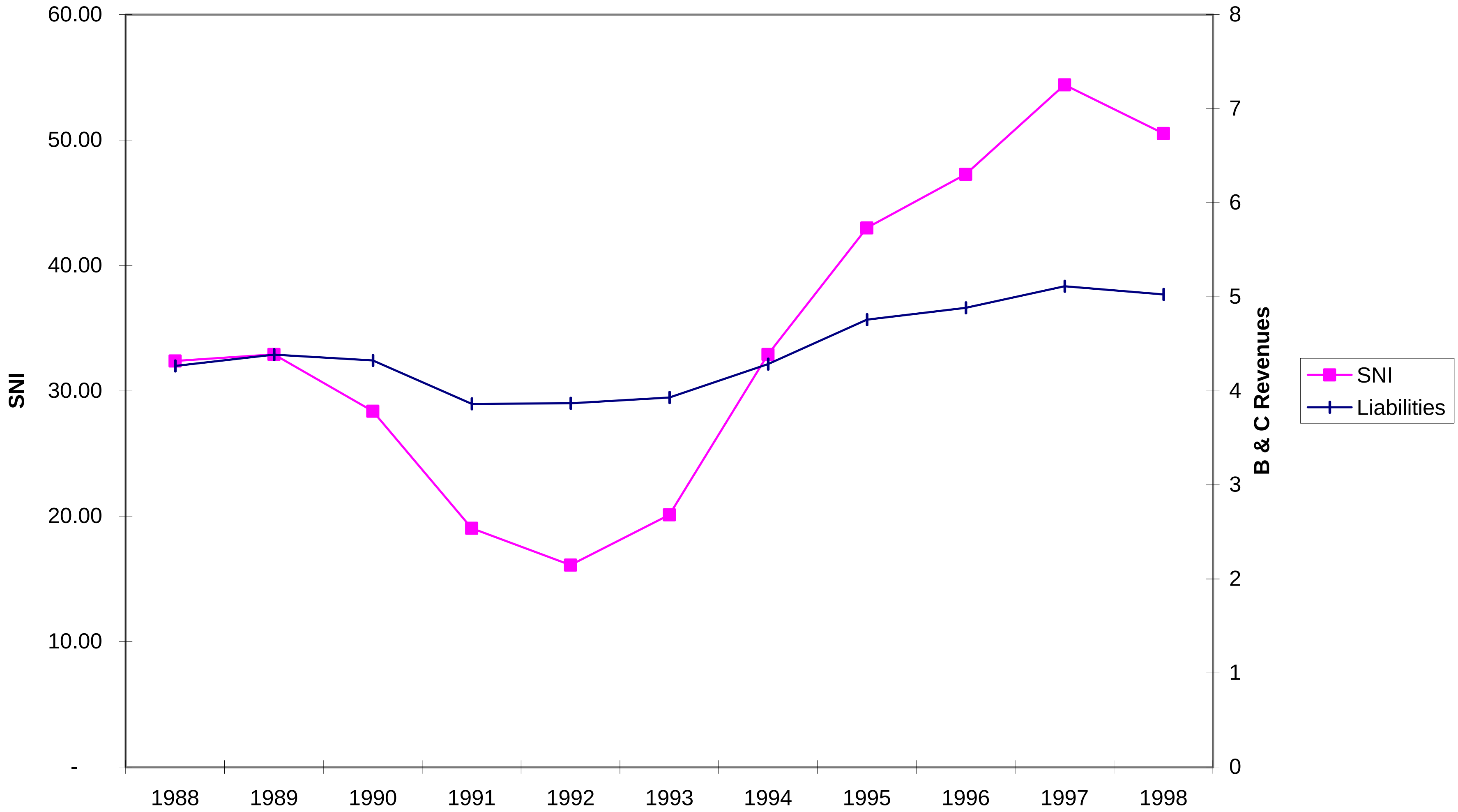


Chart 7
Positive State Net Income and Bank and Corporation Liabilities
($ Billions)

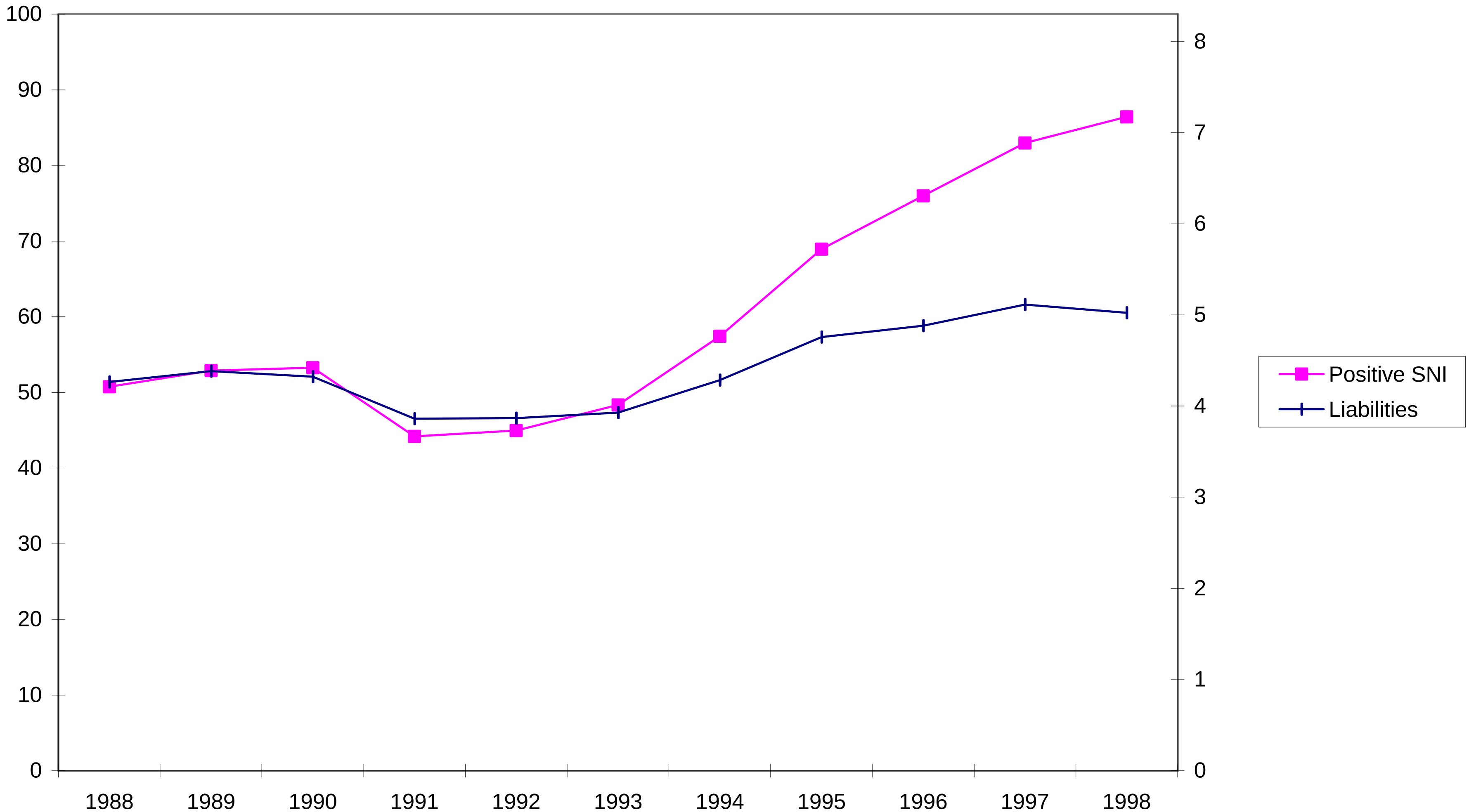
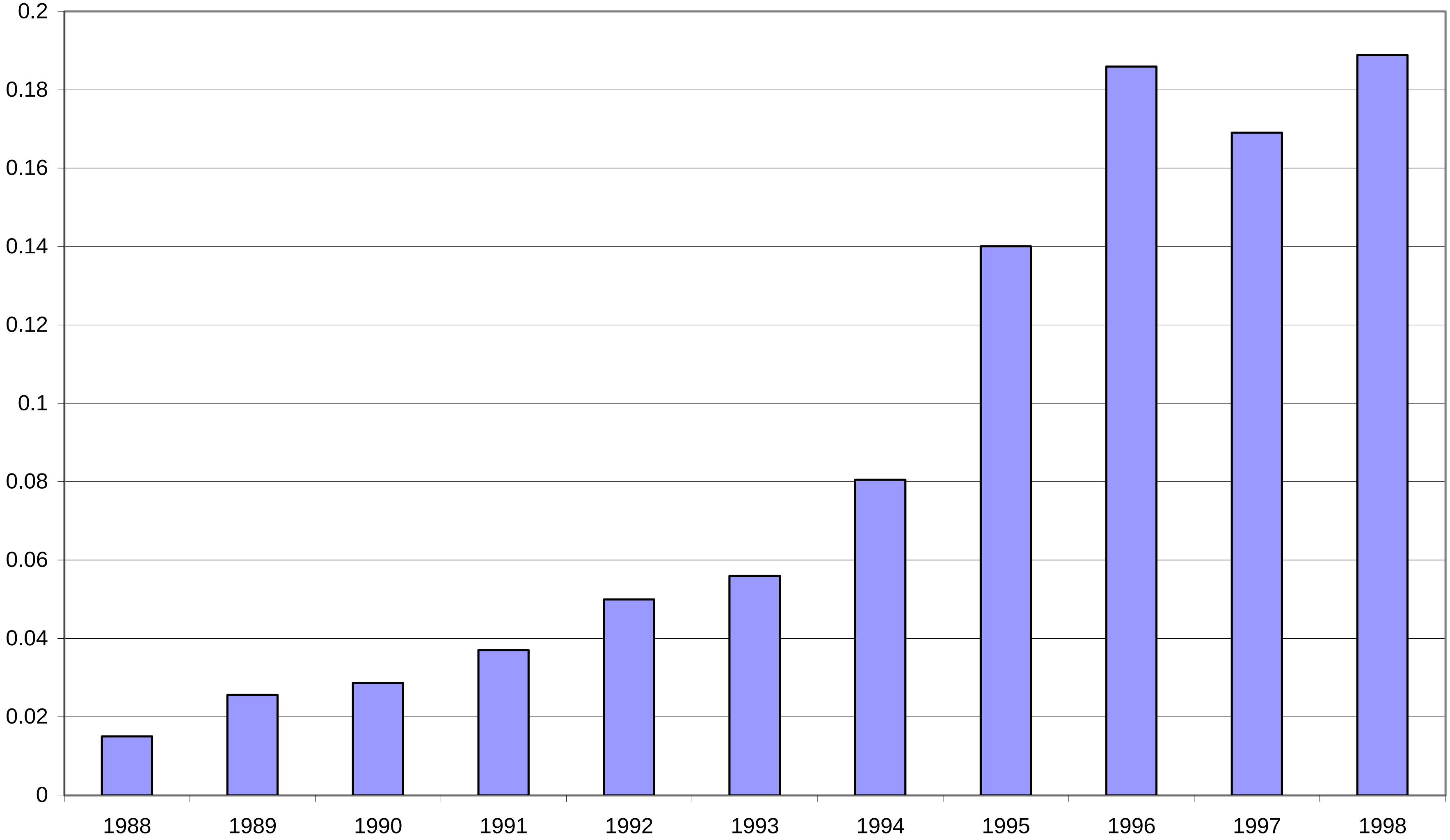


Chart 8
Credits as a Percentage of Bank and Corporation Tax Liability



Trends in Sourcing Income and Business Organization
Kathleen K. Wright CPA, JD, MBA, LLM.

1 Trends in Sourcing Income and Business Organizations.

1.1 The Nexus Controversy.

1.1.1 ARetailers engaged in Business.@

The level playing field argument relates to several issues but the current debate focuses on affiliate nexus. With little to no effort dot.com subsidiaries of traditional bricks and mortar businesses are organized outside the state and do business in the state only through electronic communications mediums. Under the existing law, electronic presence does not constitute physical presence and as long as the bricks and mortar presence is isolated in a separate corporation its activities will not taint the separate corporate activities of the dot.com part of the business. Therefore, the consumer can now go to Barnesandnoble.com and buy a book and pay no sales tax even though there is a Barnes and Noble Superstore right down the street.

"Retailers engaged in business in California" for purposes of collecting the use tax is defined by Rev and TC 6203. Rev and TC 6203 states unequivocally that all retailers engaged in business in California must collect use tax from the purchaser on the sale of property for taxable use. "Retailers engaged in business" in California include:

> Retailers maintaining, occupying or using on a permanent or temporary basis, either directly or indirectly through a subsidiary or agent an office, places of distribution, sales or sample room, warehouse, storage, or any other place of business. [Rev. & Tax. 6203(c)(1).]
>
> Retailers that have a representative, agent, salesperson, canvasser, independent contractor, or solicitor operating in the state for the purpose of selling, delivering, installing, assembling, or taking sales orders of tangible personal property. [Rev. & Tax.6203(c)(2).]
>
> Retailers deriving rentals from leases of in-state tangible personal property. [Rev. & Tax.6203(c)(3).]
>
> Mail order sellers conducting substantial and recurring solicitation of orders by mail if they benefit from banking, financing, debt collection, telecommunication, or marketing activities occurring in-state or benefits from the location in-state of authorized installation, servicing, or repair facilities. This rule applies, however, only if Congress enacts legislation authorizing the states to compel the collection of state sales and use taxes by out-of-state retailers. [Rev. & Tax.6203(c)(4).]

Rev and TC 6203(d)(1) clarifies that "engaged in business in this state" does not include orders from customers located in California which is taken over a computer network located in California which is not owned by the out of state retailer and the orders result from the electronic display of products on that same network. Rev and

TC 6203(e) also excludes from the definition of retailer engaged in business in the state a retailer whose representatives= sole reason for coming into California is to attend a convention or trade show for a limited number of days (seven or less within a 12-month period) and who also meet a de minimis gross income test.

The state can impose sales tax collection duty on out -of -state retailers only to the extent that out -of -state sellers have sufficient contacts or nexus with California. The definition of nexus must conform with the Commerce Clause definition of nexus which is "substantial." The most recent U. S. Supreme Court decision (Quill *Corp. v. North Dakota* (504 US 298(1992)) stated that the substantial nexus requirement, which must be met to satisfy the restrictions of the Commerce Clause on a state=s ability to levy tax, requires physical presence by the business within the state seeking to require the collection of the use tax.

1.2 The History of Rev and TC 6203.

1.2.1 Advertising by out of state business in California.

As a result of a series of statutory changes Rev and TC 6203 no longer defines nexus to include such tenuous activities as "advertising." In *JS&A Group, Inc. v. State Board of Equalization (No.* A07502 1, Mar. 10, 1997) The California Court of Appeal in an unpublished opinion ruled that in state broadcasters and cable operators did not serve as representatives of an out of state company simply because they had a contract with the out of state company to air their advertisements. At that time Rev and TC 6203 (e) defined a retailer engaged in business in California to include any retailer who, pursuant to a contract with a broadcaster, solicits orders for tangible personal property by means of advertising disseminated primarily to consumers in California. Subdivision (i) was the same except that it substituted "cable television operator" for "broadcaster." JS&A was engaged in direct mail merchandising of sunglasses and other health items through mail order, advertising on broadcast and cable TV and magazines. JS&A received orders by phone or mail and shipped merchandise by common carrier. They had no facilities or employees in California. The Court determined that airing advertisement did not create an agency relationship between the TV stations and JS&A. The broadcasters did not perform any of the activities that might create an agency relationship such as accepting orders, collect payments, distribute product or collect a commission on sales. The service offered to JS&A (the right to air time) was a service sold to many other clients for profit by the station, which by itself did not convert the broadcaster into an agent for the out of state seller.

Effective January 1, 1998, California repealed the offending sections which provided that any retailer who, pursuant to a contract with a broadcaster or publisher located in-state, solicited orders for tangible personal property by means of advertising disseminated primarily to consumers located in-state was considered as a retailer engaged in business in the state.

Similarly repealed was former Rev. & Tax. 6203(c)(8), which provided that any retailer who, pursuant to a contract with a cable TV operator located in-state, solicits orders for tangible personal property by means of advertising transmitted or distributed over an in -state cable TV system was considered as a retailer engaged in business in California.

Effective January 1, 2000, California repealed former Rev. & Tax 6203(c)(4), which provided that any retailer soliciting orders for tangible personal property by means of a telecommunication or TV shopping system, that utilizes toll-free numbers and is intended by the retailer to be broadcast by cable TV or other means of broadcasting to consumers located in the state is considered to be engaged in business in the state.

California also repealed former Cal. Rev. & Tax 6015.5, which provided that engaging the services of a local advertising firm, printer, or publisher to advertise to California consumers was sufficient to establish nexus. Under this repealed provision, the local advertising firm, publisher or printer was treated as an agent of the out -of -state retailer engaging their services and the retailer was deemed as a retailer engaged in business in California.

With the enactment of California's version of the Internet Tax Freedom Act, Rev and TC 6203(d) was added which makes clear that engaged in business in the state does not include the taking of orders from customers in California through a computer telecommunications network located in California which is not directly or indirectly owned by the retailer, when the orders result from the electronic display of products on that same network. In addition, under 18 Cal. Code Regs 1684 an Internet Service Provider, On-line Service Provider, internetwork communication service provider, or other Internet access service provider, or World Wide Web hosting service is not considered as the agent or representative of an out-of-state retailer as a result of the service provider maintaining or taking orders via a web page or site on a computer server that is physically located in California.

1.2.2 Conventions and Trade Shows.

Effective April 1, 1998, a retailer is not engaged in business in the state if the retailer's sole physical presence in the state is to engage in convention and trade show activities and if the retailer, his or her representatives, agents, salespersons, canvassers, independent contractors, or solicitors, do not engage in such activities for more than seven days in the state during any 12month period and did not derive more than $10,000 gross income from such activities in the state during the prior calendar year. Nevertheless, a retailer engaging in convention and trade show activities is a retailer engaged in business in the state and liable for collection of use tax for any sale of tangible personal property occurring at the convention and trade shows pursuant to an order taken at the shows. [Rev. & Tax.6203(e); 18 Cal. Code Regs. 1684(a). Therefore, if the activity at the trade show is limited as defined, then any other sales activity (such as mail order or Internet sales) would not be subject to the use tax collection requirements. Thee Governor did sign into law AB 330 which will not become effective because it is linked to AB 2412 which the Governor vetoed. Had the provisions of this bill become effective, this provision would have increased the number of days in the above referenced activities to 14 days or less and the gross income to $100,000.

1.2.3 Warranty Work.

California does not conform to the Multistate Tax Commission's National Nexus Program Bulletin 95-1 which provides that direct marketers of computers and other related items would have nexus with a state if they also provide in that state warranty repair services through independent third parties. In California an out-of-state seller is not engaged in business in California if its only contact with the state is the use of a representative or independent contractor for purposes of performing warranty and repair services with respect to items sold by the retailer. However, the ultimate ownership of the retailer and the person performing the warranty services must not be substantially similar. Ultimate owner means a stockholder, bond holder, partner, or other person holding an ownership interest. [18 Cal. Code Regs. 1684(a)

1.2.4 Franchise or Licensee of a Retailer.

Also, effective January 1, 2000, California repealed former Rev & Tax Cd. 6203(c)(6), which provided that any retailer having a franchise or licensee operating under its trade name is considered to be engaged in business in the state, if the franchisee or licensee is required to collect the tax. This provision precludes imposing the use tax collection requirements on the franchisor simply because use of its intangible assets (i.e., the company name) is present in the state.

1.2.5 Affiliate Nexus.

The concept of affiliate nexus (sometimes referred to as entity isolation) uses the corporate structure to isolate activities in a separate corporation which sells into California but does not have physical presence in California. Under this theory, a California retailer could form an out of state "dot.com" corporation that is operated separately from the "bricks and mortar" California corporation and the out of state corporation would not be required to collect the California use tax because the organizational structure has isolated an activity within a separate corporation that does not have physical presence within the state.

In *Current, Inc. v State Board of Equalization* (24 Cal. App. 4th 382 (1994)) the court held that then subdivision (g) of Rev and TC 6203 was unconstitutional and impermissible burden on interstate commerce. At that time Rev and TC 6203 (g) defined a retailer engaged in business in the state as any retailer owned or controlled by the same interests which own or control any retailer engaged in business in the same or a similar line of business in the state. Current was an out of state mail order company whose principal place of business was in Colorado. Current had no physical presence in California until it was acquired by Deluxe. Although Deluxe was not organized in California, it did have a physical presence in the state and did hold a California seller's permit. Deluxe sold checks primarily to financial institutions and their depositors. Current also sells checks but that activity represented a small percentage of their volume. They sold primarily greeting cards and other novelty items. They were only affiliated with each other through ownership, i.e., they did not use the same trade name, marketing practices or customer lists. They did not have integrated operations or management and Deluxe did not serve as the agent for Current in California. The court held that Current did not have nexus with California based on its relationship with Deluxe. The court stated that printing alone was not sufficient to place the two companies in a similar line of business. With differing products and distinct management and marketing activities, the test of Rev and TC 6203 (g) was not met.

Effective January 1, 1996, California repealed former Rev. & Tax.6203(g) based on the Current decision.

1.2.6 The New Twist

AB 2412 (Migden) specifies that a retailer is presumed to have an agent in the state if the retailer holds a substantial ownership interest either directly or through a subsidiary in a retailer maintaining sales locations in

California or is owned by such retailer directly or indirectly. The presence of an agent within the state would create nexus for the out of state retailer. "Substantial ownership interest" is defined by reference to 15 USC Section 78p (which means ownership interest of any equity security of more than 10%). In addition, for the agency relationship to exist, the retailer must sell the same or substantially similar line of products as the retailer maintaining sales locations in California under the same or substantially similar business name, or facilities or employees of the related retailer located in California. The act states that it is effective January 1, 2001 and that it is a clarification of existing law. Governor Davis has vetoed this bill. In his veto message he stated that the Internet should be allowed to develop unencumbered with restrictions such as proposed by Ab 2412.

California has successfully used the agency argument to impose nexus on out of state businesses, but much more was required than what is required under AB 2412. In *Scholastic Book Clubs, Inc. v. State Board of Equalization* [207 Cal. App. 3d 734 (1989)] the California Court of Appeal ruled that an implied agency relationship existed between the out of state corporation and the California teachers who assisted in selling the taxpayer's goods within the state. Although Scholastic Books did not maintain any property in California, it did market its books through mail order catalogues and order forms sent to the teachers. The teacher then solicited orders from students who made selections and paid the teacher for the items selected. The teacher consolidated the order and remitted the payments to the taxpayer. The books were shipped to the teachers who then distributed the materials to the students. The Court held that the teachers were acting under the taxpayer's authority by accepting the orders, payment and shipment of merchandise, all activities ratified and confirmed by the taxpayer. The reliance on the teacher as the conduit to the student was the lynchpin that created an implied agency relationship and nexus with the state. (Note that although Kansas and California Courts of Appeal have ruled that an implied agency exists, the Arkansas Supreme Court, the Michigan Court of Appeals and the Ohio Board of Tax Appeals have ruled to the contrary.)[1]

Under existing Rev and TC 6203 (c)(2) the mere presence of a retailer's agent or representative in California, is not a sufficient basis to impose use tax collection duty on the retailer. If the agent or representative operates in California for the purpose of selling, delivering, installing, assembling, or taking of orders for tangible personal property sold by the retailer then nexus may result. Therefore, under existing law the physical presence of the agent or representative in California must be connected with the sale of tangible personal property to impose use tax collection requirements on the out of state vendor. Display of a banner by the cash register on the way out of the Barnes and Noble Superstore which states "Visit us on our Web site!" is not a connection with the sale of

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[1] *Arkansas Department of Finance and Administration v. Troll Book Clubs Inc.,* 871 S. W.2d 3 89 (Ark. 1994) (Club not liable); *Scholastic Book Clubs v. State of Michigan,* et al. M1893 86 (Michigan Court of Appeals, May 20, 1997) (Club not liable); *Troll Book Clubs Inc. v. Roger W. Tracy, Tax Commissioner of Ohio, No. 92-Z-590* (Ohio Bd. of Tax Appeals, 1994) (Club not liable); *Freedom Industries Inc. v. Tracy, Tax Commissioner of Ohio,* No. 92-X-597 (Ohio Bd. of Tax App. 1994) (Seller not liable).

tangible property from Barnesandnoble.com to the purchaser. If, however, merchandise purchased over the Internet is returnable to the bricks and mortar location, then we are getting closer to establishing nexus in that this is an activity associated with the sale of the tangible personal property.

Under Rev and TC 6203 (c)(1) if the retailer has a place of business in the state, then that physical presence will create nexus even if that place of business has no connection with the sale of tangible personal property. (See *National Geographic Society v. Board of Equalization* [(1977) 430 U.S. 551] where the conclusion of the Board was upheld by the California Supreme Court. In that case National Geographic made mail order sales of tangible personal property to California purchasers. The taxpayer did have two offices in California that solicited advertising for the Society's magazine but had nothing to do with the sales of tangible property. The Board concluded that this "slightest actual presence" was enough to assert that the Society was engaged in business in the state.

If the retailer has an agent or representative in the state who is operating on the retailer=s behalf, then there is physical presence, but that presence alone is not enough to satisfy the substantial nexus requirements of the Commerce Clause and Rev and TC 6203(c)(2). If the agents or representatives are operating on behalf of the retailer in connection with the sale of tangible personal property then the substantial nexus requirements are met. That means the agent takes orders, receives payment, distributes merchandise or handles returns of merchandise sold by the principal. To state that something less than this constitutes nexus is a change of existing law.

Another argument to bring these retailers within the net of required use tax collection, focuses on "affiliate programs.@ Under these programs= commissions are paid to companies that result in sales by the out of state retailer to customers referred to their Web sites by the affiliate. The customer referral is through Links on the affiliates Web pages to the electronic booksellers (like Amazon.com). The argument is that the level of technical support provided to the affiliate (including banners and other "cover art" for the Web page, online reports to monitor performance, and interviews with author and other book reviews) would be enough to create nexus in California if the affiliate had a bricks and mortar presence in the state. With California's drift away from asserting that advertising creates nexus, this argument is tenuous at best. The physical location of the affiliate within the state is simply not connected with the sale of the tangible property. All the affiliates has is a link to the out of state retailers= online bookstore and (at least in California) that does not appear to be enough.[2]

[2] For other recommended solutions see "The Practice of Corporate Entity Isolation: Past, Present and Future" by Tim Fallow. (2000 STT 152-27, August 4, 2000). See also "Current and Quotable: Letter from the Northern California Independent Booksellers Association to David H. Levine, Supervising Tax Counsel of Board of Equalization, (2000 State Tax Today, Feb. 8, 2000). See also "Nexus, Use Tax and California: What Is, What May Be" by David H. Levine. Remarks given at 1996 California Tax Policy Conference (Nov. 6-8, 1996). And also see SBE Staff Legislative Bill Analysis for AB 2412 (Migden).

2 Apportionment of Electronic Commerce.

2.1 The Sales Factor Applied to Electronic Commerce.

The sales factor raises several issues when applied to electronic commerce due to the ambiguity inherent in the definition of tangible property versus intangible property. As provided in UDITPA, when products that have been sold are treated as tangible property most states source the sale to the destination state. When the products are treated as sales of services or intangibles, California will attempt to source the income based on where the income producing activity occurs, or where the greater cost of performance occurs (which would typically be where the headquarters is located). Assigning a sale based on cost of performance duplicates the effect of the payroll and property factor and does not reflect the location of the consumer (i.e., the market state).

The distinction between tangible versus intangible property will be most relevant to seller of personal property solicited through an electronic medium which are shipped from a point outside the state. If the property is clearly tangible property then the taxpayer is probably protected by Public Law 86-272 (assuming that the taxpayer had no activity in the state other than solicitation). Access to customers through the Internet does not meet the physical presence test which is a result consistent with telephone communication and the U. S. Mail. Some states have argued that leasing property is not an activity protected by Public Law 86-272 and that the license agreement that frequently prevents duplication and distribution of a software package is tantamount to a lease of tangible property and not a sale. We are still waiting for the right case to test this issue.

If the item sold is tangible property and the seller is not protected in the destination state by Public Law 86-272 and the market based rule applies, then the seller must know where the item is going to be used. If it is truly tangible property which is shipped by common carrier, then at least the delivery address is known. If, in the alternative, the seller is selling software (and the state defines the sale of software as the sale of tangible goods) which is downloaded, then the seller may not know the location of the buyer where the information is received. This could be the case for credit card sales and sales through other financial intermediaries (i.e., cybercash). Technically, throwback does not apply and Anowhere@ income is created (i.e., income included in the denominator of the sales factor but not included in the numerator of any state.) That result is not generally tolerated by tax administrators but is embraced with enthusiasm by practitioners. Most of the discussion today talks about Are-engineering@ this computation to avoid this result, but nothing definitive yet.

Since many of the items sold over the Internet involve information services and other forms of property which are not tangible, California assigns the sale to the location where the greatest income producing activity has occurred, measured by cost of performance. Cost of performance includes only direct costs and generally gives an all or nothing result. In other words, if significant costs are incurred in several states, the sale is assigned to the state which has the greatest cost. [3]

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[3] 18 Cal Code Reg 25136.

Again the taxpayer finds himself adrift in a sea of uncertainty in that the task of apportionment requires the taxpayer to determine the direct cost of the income producing activities. In cost accounting terms this sounds like the taxpayer is being asked to identify the cost driver (the activity that generates the cost), to allocate costs over these activities and then determine where the activities are located. Allocating costs over activities has become known in accounting circles as activity-based costing.

Application of this concept to electronic commerce is difficult. The Internet Service providers provide the subscribers with point of presence (POP) networks which are generally rooms with modems and routing equipment with a local phone number for use by the subscriber. The subscriber can either dial up or purchase a dedicated line generally over transmission lines owned by the local phone company. Once connected to the point of presence network, the call is then routed to the ISP=s Hub where the subscriber=s identification information is verified before being re routed to the POP and assigned an Internet Protocol Address. The subscriber is charged for the local call to the POP network and the balance of the transmission costs are borne by the ISP. If the call is the cost driver, then determining the direct cost of each call would be mind boggling, and allocating the cost to all the different states would also be an exercise in futility. No definition is provided for Adirect cost@ and the ISP costs span several states.

If the taxpayer is an information provider then the bulk of the cost will probably be associated with maintaining the data base. Although it may be a little easier to determine where the costs are incurred, under the all or nothing test of the cost of performance rules, all of the service fees charged for accessing the data base will be sourced to the state where the data base is maintained. This result certainly destroys the intent of the sales factor, which was to source part of the income from the sale to the market state.

Much of what is sold over the Internet is software. This transaction forces the issue of determining whether software sales are sales of tangible or intangible property. Black=s Law Dictionary defines tangible as having or possessing physical form, capable of being touched and seen; perceptible to the touch; tactile; palpable; capable of being possessed or realized; readily apprehensible by the mind; real; substantial. While the definition of tangible property under the sales tax laws are not direct authority for income tax purposes, the California Supreme Court has recently addressed the issue of sales of computer software in *Navistar International Transportation Corporation v. SBE*[4]. Navistar had sold all of its assets in its Solar Division to Caterpillar including trade secrets and other intellectual work products. In addition, part of the assets sold included computer programs which Navistar had developed for its own use. The computer programs at issue here had been developed by Navistar's Solar Division for use in its own business. Approximately 74 percent of the programs were business system programs pertaining to financial accounting, business operation planning, and economic forecasting; roughly 18 percent of the programs were engineering programs, such as design and testing programs; and approximately 8 percent of the programs were "distributed computing systems," such as

[4] 8 Cal. 4th 868; 884 P.2d 108; 1994 Cal. LEXIS 6032; 35 Cal. Rptr. 2d 651; 94 Cal. Daily Op. Service 9013; 94 Daily Journal DAR 16722, (November 28, 1994, Decided)

computer-aided design programs, basic research programs, and programs that controlled automated machinery operations. The computer programs also contained trade secrets.

For sales tax purposes the taxability of software depends on whether the Atrue object@ of the transaction is the sale of services or property, and in the case of software whether the software is custom or canned. The taxpayer argued that the items at issue were not subject to tax because they were used solely as a means of conveying trade secrets from the seller to the buyer, and therefore qualified under the exception that sales tax is not imposed if the true object of the transaction is the rendition of services. Under California Sales and Use tax Regulation 1501 if the true object of the contract is the service, then the property used solely as the medium for the expression of an idea or concept is nontaxable. The SBE contended that the items constituted tangible personal property because they had value as physical objects and were not sold incident to any service performed by Navistar.

The Court agreed with the SBE in finding that the true object test did not render the sale of a physical object exempt from taxation whenever the item was acquired primarily for its intellectual content. The regulation also required that the transfer of tangible personal property must be incidental to the performance of a service which was simply not the case in the sale of the documents by Navistar. The Court also rejected the argument that the software sold retained its designation as custom computer programs. Once the software was created for internal use, it became a tangible personal asset of the taxpayer. A subsequent sale of the program developed by the taxpayer for his use was not custom software developed for a customer, but rather a sale subject to the sales tax.

If the sale of software is characterized as the sale of tangible property the medium of delivery (i.e., over the Internet or through the U. S. Mail) should not affect the inclusion of the sale in the sales factor of the destination state. Consistency would mandate the same result. Assume that GISO Inc. (a seller of software) has their headquarters in Cupertino and a warehouse in San Mateo (both in the Silicon Valley in California). Geek a consumer accesses the Internet and buys their software and downloads it directly from GISO=s Web Page. If the sale is tangible property, then the sale is protected from inclusion in the Arizona numerator of the sales factor if GISO has no presence in Arizona other than through Geek, a consumer. The sale would be thrown back to California and included in the California numerator. If GISO had a subsidiary with which it was unitary which was taxable in Arizona, then the sale to Geek would not be thrown back to California. Since California=s tax rates remain high, corporations with multistate operations tend to benefit from the current definition of throwback.

2.2 The Property Factor Applied to Electronic Commerce.

The property factor is the ratio of California real and tangible property rented or owned to the total of such property everywhere. Thus, intangible property is not included in the standard UDITPA property factor. Although an argument can be made for including intangible assets in the property factor since such assets generate income of the business, as a practical matter, it is frequently difficult to determine where intangible property is located. Not only is it difficult to source the intangible to a geographic area, it is also difficult to value the intangible which may have been acquired for substantial cost or for free.

Another issue related to the property factor is whether payments to Internet access providers (such as telecommunications companies) who provide the lines and equipment which allow access to the Web are actually rent payments which should be included in the property factor at eight times the annual payment. Industry practice is to treat this expenditure as payment for a service (i.e., not include it in the property factor).

The Franchise Tax Board has had prior experience with taxpayers who operated property in Aspace@ and as you might expect the result was not good. Note that this case involved outer space instead of cyberspace, but one black hole is as good as another in this area where precedent is sorely lacking. The case, *Communications Satellite v. Franchise Tax Board*[5], involved computation of the property factor for a company which operates a global commercial communications satellite system. Although the satellites orbited in outer space, the earth stations transmitted signals to and received signals from the satellites. One of the earth stations was located in California. The company leased half circuits, i.e., a two-way communication channel between a satellite and an earth station.

For purposes of computing its apportionment formula, the taxpayer included the value of the earth station and a small office in Los Angeles in its property factor. The taxpayer did not include any value associated with the satellite in the numerator but did include its value in the denominator. This in essence created Anowhere property,@ property which would not be included in the numerator of any state. The taxpayer left out the value of the satellite on the basis that the property was not located within the state. The Court agreed with the Board that the test is not located within the state, but rather owned and used in the state. The court went on to hold that there is an invisible but apparently continuous and very real connection between the earth station and the satellites. The earth station has a value only because this connection exists and it is otherwise of no value. With the connection the satellites were deemed to function in California, which the Court concluded was a recognition of the realities of telecommunications and space technology, not an indulgence in fiction.

If the test is not location of property, but rather ownership of and use of property in the business activities conducted within the state - it is not much of a leap of imagination to extend the test to intangible assets such as copyrights which are clearly owned and used by information providers, access providers and sellers of property in electronic commerce. The bigger obstacle will be modification of the traditional view that intangible assets are not included in the definition of Aproperty owned and used within the state.@

3 Setting up a Business in California.

There are several ways a client may start a business. This chapter discusses the various business and form filing considerations associated with each of the different entity forms. The initial consideration is whether to buy an existing business or start a business from scratch.

[5] 156 Cal App. 3d 726 (1984).

Starting a business from scratch is easy, cheap and allows complete independence. There is a great deal of risk involved in starting a new business. Many new businesses do not succeed. The client is solely responsible and that means financing may be problematic.

When the client buys an existing business, the infrastructure is in place, a client base is established, and there is already name recognition. Past records let the client know what the client is getting and make it easier to finance. This option can be less risky than starting a new business.

An existing business may have undisclosed liabilities. This is frequently why the client will want to buy assets. The client may not be able to escape liability for these debts and or subsequently filed lawsuits. Since the business reputation of your client is tied to that of the previous management, it may be difficult to escape liability for pre-existing debts even if your client is not legally required to pay. Occasionally, the previous owner may impact your business by starting a competitive operation, and your client may need to consider entering into a covenant not to compete with the previous owner.

Buying a franchise is a way to reduce risk and receive support from a large network. The preliminary work has been done with an infrastructure well established, a product line in place, and the marketing strategy developed. The Franchisor usually provides management assistance and training, advertising, name recognition, a customer following and may offer financial support. The pooled resources of many franchisees allow strong promotional opportunities and group buying power.

A franchise offers less freedom than an independent business. There are lots of rules and procedures in place. The owner cannot change products and services. Initial franchise fees may be expensive. The client needs to take into consideration start-up and operational costs as well as ongoing royalty and other payments to the Franchisors. Transfer of ownership may require approval of the Franchisors.

If the client opts to start a business from scratch or to buy assets of an existing business then the client must choose an entity form. The balance of this chapter reviews some of the business considerations of operating various different types of legal entities. Subsequent chapters discuss in detail the tax consequences of operating the various entities in California.

4 Sole Proprietorship

The simplest entity to operate and form is the sole proprietorship. There is no need to file Articles of Incorporation (as with a corporation or an LLC, but the taxpayer may have to obtain a business license to do business under state law and local ordinances. In California, most professions are required to be licensed through the Department of Consumer Affairs which imposes varying requirements depending on the profession.

A taxpayer is generally required to obtain a California seller's permit if the taxpayer sells or leases merchandise, vehicles, or other tangible personal property in California. A seller=s permit is a state license that allows the taxpayer to sell items at the wholesale or retail level. The client cannot legally make sales of taxable products in California without a seller=s permit. If the taxpayer makes sales at more than one location, a separate permit is necessary for each location. When the taxpayer obtains a sellers permit, the taxpayer is entitled to purchase property for resale without paying tax to the supplier. By providing the vendor with a completed resale certificate, the taxpayer is not required to pay sales tax on tangible personal property purchased for resale. If the taxpayer intends to use the property instead of selling it then the taxpayer must pay the sales tax. The permit is obtained from the State Board of Equalization.

In addition, if the business is going to operate under a name other than the name of the owner, then the taxpayer will have to file an assumed or fictitious business name certificate at a local or state public office. The reason for this requirement is so that persons doing business with the entity will know who the real owner is. Generally a county office handles the filing procedure for the fictitious name which is frequently referred to as a *dba* filing. For example, if Bud Man operates a flower shop under the fictitious name of This Buds for You, he would be Adoing business as@ This Buds For You.

One of the most significant reasons that a taxpayer will opt for a corporation or an LLC is limited personal liability. In a sole proprietorship, where there is unlimited liability, if the taxpayer produces more than he can sell then the taxpayer will be personally liable for the debts of the business. A well-designed insurance program can take some of the risk out of conducting business as a sole proprietorship. This course is not meant to cover all of the different types of insurance policies available, but a few basics are mentioned.

Most business will carry some form of property insurance that protects against risk of fire, lightening, explosion, windstorm, smoke, vandalism, leaks, sinkholes and volcanoes. Earthquake and mud slides are generally considered separate risks for which separate polices are purchased. Most insurance companies do not provide insurance against mud slides. Most policies are written either at replacement cost or for current value. If the structure is old, replacement may be quite a bit more expensive to comply with current legal standards for fire and earthquake.

Small business will also need to consider liability insurance to cover liability to people injured and their property which may have been damaged because the taxpayer or his employees did not use reasonable care. A form of liability insurance is product liability insurance which covers items which the taxpayer designs, manufactures or sells. Cars and trucks owned by the business must also be covered under liability insurance policies. In addition, if employees drive their own vehicles for business purposes, coverage would need to be obtained to for accidents which may occur while the employee is driving their own car in the course of employment.

Worker=s compensation is also required in California. This form of insurance covers the employer=s liability for injuries received by employees on the job. The taxpayer who operates as a sole proprietor cannot cover himself under his own worker=s compensation policy for injuries, he may sustain on the job. Further, the sole proprietor is not required to carry workers= compensation insurance on independent contractors. The law in this area becomes much more complex where an independent contractor comes on your premises to perform work and brings their employees. If the independent contractor does not carry workers= compensation for his workers, then liability could be asserted against the sole proprietor.

Today most fringe benefits available to corporate employers/employees are also avail able to the self-employed. The deduction for medical and health insurance is the one area where the corporation gets a full deduction, but the self-employed gets a fraction (60% for 1999). The percentage allowed as an above the line deduction is scheduled to increase up to 100% of the amount paid. Rev and TC 17273 conforms California law to the federal increase in the percentage of the self-employed health insurance allowed as an above the line deduction.

5 Partnership.

If two or more people are going to operate the business then the taxpayer must choose between establishing a partnership, a corporation or a limited liability company. If the partnership is chosen, then it is generally recommended that an agreement amongst the partners be drawn up. A partnership agreement is not required, but in California (and most states) if the taxpayer does not have an agreement then various aspects of the business will be governed by the Uniform Partnership Act.

The California Corporations Code codifies the Uniform Partnership Act of 1994 and as amended in 1996. These provisions apply to general partnerships formed on or after January 1, 1997. General partnerships formed before January 1, 1997 may elect to be governed by the Uniform Partnership Act of 1994 as amended in 1996. After January 1, 1999, all partnerships will be governed by the Uniform Partnership Act of 1994, as amended. One of the objectives of this act was to centralize the filing of public information related to general partnerships. All general partnership statements filed with the Secretary of State=s Office pursuant to the Act are permissive and not mandatory at this time. The client may choose to file a Statement of Partnership Authority to put the public on notice of who the partners are behind the name of the partnership. This is generally recommended if the partnership is going to operate under a fictitious name.

Note that defaulting to the UPA generally makes sense (and may be what the parties would do by agreement) but it is substantive. In other words, the UPA provides that all partners will share profits equally and will have an equal voice in management. In addition the UPA states that partners are not entitled to be paid for their services. With a written agreement the parties can address these issues based on their own objectives.

General partnerships may record their partnership agreement at the county level at the County Recorders office in the county where the general partnership is located. They may also register with the State at the Secretary of State=s Office. The filing of general partnerships is permissive. The fee for filing a Statement of Partnership Authority with the Secretary of State is $70.00.

Generally it is advantageous to have a partnership agreement which covers such topics as the following:

$ Voting majority rules.

- $ Whether voting will be per capita, according to contribution, or by some other method.
- $ The manner in which an agreement may be amended.
- $ Restrictions on the removal of partners.
- $ Limiting or permitting self dealing by partners and managers.
- $ Requiring agreements to be in writing.
- The manner of allocating profits and losses and other tax items among the partners.
- $ The manner of allocating distributions among the partners.
- $ Restricting the resignation or withdrawal of a partner.

In a partnership any partner can bind the partnership. It is not necessary that the other partners agree to an action taken by another partner. The act generating the liability can be the signing of a contract to purchase supplies, or injury to others through negligence on behalf of the one of the partners in carrying out his responsibilities. Partners rights are governed by the partnership agreement and by state law. Partners generally have the right to be informed of the partnership affairs and partners have a fiduciary duty to one another. This means that they must act in good faith the deal fairly with the partnership. Partners must vote to admit a new partner and technically dissolve when a partner withdraws or dies. In California the partnership is not automatically dissolved, but can continue the existing partnership rather than form a new one.

6 Limited Liability Companies

The tremendous growth of the LLC statutes represents the explosion of interest in the LLC form. Because the LLC is an amalgam of different characteristics of corporations and general and limited partnerships, LLC statutes contain a number of provisions borrowed from each of these other sources. As is perhaps not surprising, there is a wide diversity of statutory provisions which may be healthy for the growth and development of the law. It may be a confusing phenomenon for multi-state LLCs who try to comply with varied requirements in 50 states.

The California Limited Liability Company Act (L. 1994, c. 1200 (SB469)) allows limited liability companies (LLCs) to organize and do business in the state. The Act also allows LLCs organized outside California to do business in California after registering with the Secretary of State. Foreign LLCs are governed by the laws of the state where they are organized, a provision discussed in more detail herein. The statute has been amended several times with various clean up provisions which are discussed herein.

The LLC is formed by filing Articles of Organization with the Secretary of State. Recent legislation allows an LLC to record its articles of organization in the office of any county recorder in the state. The Articles of Organization must set forth the name of the LLC which must end with the words "limited liability company" or the abbreviation "LLC.@ Since LLCs is a new form of organization, plenty of names are available. If the business was operated in another form and is converting to LLC status, it can continue to use its existing name with the addition of ALLC.@ The Articles of Organization must also include the latest date or event upon which the LLC is to dissolve, the purpose of the LLC, information regarding the LLC's agent for service of process; and a statement regarding the delegation of management to managers (if the LLC opts for a form of centralized management). In the application for the license to do business, the LLC must include the names and addresses of any managers and officers owning more than 10% of the LLC, and file written notice of all changes in ownership of the members of

10% or more of the LLC.

The domestic limited liability company must complete and file Articles of Organization (LLC-1) with the Secretary of State accompanied by a filing fee of $70.00. The foreign limited liability company must complete and file an Application for Registration (LLC-5) with the Secretary of State. A certificate of good standing from the home state must accompany the Application for Registration. The fee is the same as for domestic LLCs or $70.00. The forms can be obtained at the Secretary of State web site at www.ss.ca.gov.

AB 831 (Leach, CH 99-490) authorizes the organization of single-member limited liability companies (LLCs) in California, effective for LLCs formed on or after January 1, 2000. In prior years, California would have required each LLC to have two members.

Under federal law, a business entity is classified as either a Acorporation per se,@ treated and taxed as a corporation, or an Aeligible entity@ entitled to elect its classification. If the eligible entity has only one member, it will be disregarded as an entity separate from its owner unless it elects to be treated as a corporation. If the eligible entity has two or more members, it will be taxed as a partnership unless it elects to be classified and taxed as a corporation. Any Aeligible entity@ that fails to make a proper election will be classified according to default classification rules:

With regard to domestic entities, an eligible entity with a single owner is disregarded as a separate entity;
An eligible domestic entity with two or more owners is classified as a partnership;
With regard to foreign entities, an eligible entity with a single owner is disregarded if its single owner does not have limited liability;
A foreign entity in which all members have limited liability is classified as a corporation; and
A foreign eligible entity with two or more owners is classified as a partnership if at least one member does not have limited liability.

Thus, for federal purposes, a corporate-owned, single-member LLC that files a federal form 966 is disregarded and, for tax purposes, effectively disappears and is treated as a division or branch of its corporate parent. An individually owned single-member LLC that is disregarded is treated as a sole proprietorship.

The LLCs existence begins with the filing of the articles of organization with the Secretary of State. A California LLC can organize to conduct any lawful business except banking, insurance, trust company operations, or professional services for which a license, certification or registration is required pursuant to the California Business and Professional Code.[6] The professional services required to be licensed by the state of California are set forth in the following chart. Although the statute may permit operation through an LLC, practitioners are cautioned that they must first confirm with the appropriate regulatory authority that such authority will issue a license, certificate or registration to an LLC.

The important legislative consideration in deciding whether the LLC form is appropriate to a professional practice is how to limit the liability. In states which have allowed professionals to form as LLCs, the statute will typically provide that the members will not be personally liable for the debts and obligations of the LLC to the

[6] Corporations Code 17002 and Section 93 of the Act

extent such debts and obligations are attributable to the negligence or wrongful acts of the LLCs other members or employees. The limited liability made available by an LLC will protect a professional from the actions and commissions of co-members but will leave intact the professional's individual responsibilities.

Although insurance agents and insurance brokers are not governed by the Business and Professions Code, the Department of Insurance initially took the position that agents and brokers may not conduct business in an LLC form. The Department=s position is based on its reading of Cal. Corp. Code 17002 which provides that an LLC may engage in any lawful business activity except the banking, insurance or trust company business. This result has now been changed by AB 2177 (Miller) signed by the Governor on September 26, 1996.

AB 2177 allows insurance agents, brokers and surplus line brokers to organize their agencies as limited liability companies. The bill does impose certain minimum security requirements which are summarized as follows:

> Any agent or broker must maintain a policy or policies of insurance against liability imposed on or against it by law for damages arising out of claims in an amount for each claim of at least one hundred thousand dollars ($ 100,000) multiplied by the number of licensees rendering professional services on behalf of the company, with a minimum required amount of five hundred thousand dollars ($ 500,000); however, the maximum amount of insurance is not required to exceed five million dollars ($ 5,000,000) for claims initially asserted in anyone calendar year, less amounts paid in defending, settling, or discharging those claims.
> Maintain in trust or bank escrow, cash, bank certificates of deposit, United States Treasury obligations, bank letters of credit, or bonds of insurance companies as security for payment of liabilities imposed by law for damages arising out of all claims in an amount of at least one hundred thousand dollars ($ 100,000) multiplied by the number of licensees rendering professional services on behalf of the company, with a minimum required amount of five hundred thousand dollars ($ 500,000); however, the maximum amount of security is not required to exceed five million dollars ($5,000,000) for claims initially asserted in any one calendar year, less amounts paid in defending, settling, or discharging those claims.
>
> For purposes of satisfying the security requirements of this section, a limited liability company may aggregate the security provided by it pursuant to the above two paragraphs.

In addition to the minimum insurance requirement, the limited liability companies must also file with the Department of Insurance evidence of compliance with the minimum security requirements outlined above.

The California statute does require that before filing the articles of organization the members will have entered into an operating agreement. An operating agreement is the LLC analogue to a partnership agreement, and constitutes an agreement among all the LLC's members regarding the operation of the business of the LLC. In general these agreements address issues that later arise among the members relating to voting, management, financial decision making, changes in a membership, and ultimate dissolution of the LLC. The operating agreement of an LLC (unlike the articles of incorporation of a corporation) does not have to be filed in order to be effective. Since the operating agreement is not required to be publicly filed, there is no required disclosure of financial relationships among the members.

Note that there is no restriction that must be included in the operating agreement (or the articles of organization) regarding the number of members or the rights and duties of different classes of stock. [7]

The LLC may be managed by a single member, an outside manager or a management group that consists of some members, some nonmembers or both. There is no requirement in the statute that managers are elected annually, or that regular meetings of members and managers are held. This provision results in less risk of piercing the corporate veil (i.e., requiring shareholders of a corporation to satisfy liabilities and obligations of the corporation out of their personal assets). This is helpful for a small corporation where corporate formalities are largely ignored.

The LLC must continuously maintain in California an office where records are kept concerning:

The name, addresses, capital contributions, and shares in profits and losses of members and holders of economic interests;
The names and addresses of the managers;
The Articles of Organization, Operating Agreements and any related amendments;
Federal, state and local tax returns for the six most recent taxable years;
Financial statements for the six most recent years;
Other relevant books and records for the past four fiscal years.

The California statute requires foreign limited liability corporations to register to transact business in the state. The foreign limited liability company is defined broadly and includes, an entity formed under the limited liability company laws of any state other than California, or an entity organized under the laws of any foreign country that is an unincorporated association and is organized under a statute under which an association may be formed that affords each of its members limited liability with respect to liabilities of the entity.

A foreign LLC is governed by the laws of the state or foreign country under which it was organized [Cal. Corp. Cd. ' 17450]. This is an unusual provision as in most cases the law of California governs transactions taking place within the state. Such a provision also results in judges in California Superior Court having to apply the law of another state to resolve disputes.

"Transacting intrastate business" means entering into repeated and successive transactions of business in California, other than in interstate or foreign commerce. A foreign LLC won't be considered transacting intrastate business merely because its subsidiary transacts intrastate business or because it is a shareholder of a domestic corporation or a foreign corporation transacting intrastate business; limited partner of a domestic limited partnership or a foreign limited partnership transacting intrastate business; or member or manager of a domestic LLC or a foreign LLC transacting intrastate business [Cal. Corp. Cd. ' 17001(ap)(1)].

A person won't be considered as transacting business in-state solely because of its status as a member or manager of an LLC [Cal. Corp. Cd. ' 17001(3)]. These provisions provide much needed clarification (and liberalization) or the provisions that govern the concept of doing business in the state.

A company doing business in California as an LLC without registering is subject to a penalty of $20 per day, with a maximum of $10,000. In addition, the member=s personal liability is not limited while the company remains unregistered.

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[7] Corporations Code 17102

This provision provides planning opportunities. If the LLC statute in California contains a provision that the members wish to avoid (such as naming member managers or the requirement of two members) then the LLC could form under another state's law where that requirement does not exist. The corporation would then register to do business in California. California's statute does not impose the requirements of identification of managers on foreign LLCs.

7 Limited Partnerships.

The limited partnership requires that there be one or more general partners and one or more limited partners who are not actively involved in management and serve more of an investor function. The general partner is personally liable for the debts of the partnership and the limited partners are only liable for capital contributions or any distributions that they may have received after the partnership became insolvent.

The limited partnership is generally viewed as a way to raise money from investors. The cost of doing business as a limited partnership is less than the cost of doing business as a corporation or as a limited liability company, (i.e., $800 minimum franchise tax) but the limited partners cannot participate in the business. Some venture capitalists would prefer to have some say in the management of the entity and a limited partnership interest may not be suitable. If a limited partner does become actively involved, then they risk losing immunity from personal liability.

All limited partnerships have been required to file with the Secretary of State=s Office since July 1, 1984. Prior to that date, limited partnerships filed documents with the County Recorder=s offices in the county or counties in which they were doing business. In order to form a domestic limited partnership, the general partners shall file a Certificate of Limited Partnership (LP-1), a form prescribed by the Secretary of State. In addition, before or after the filing of a certificate, the partners shall have entered into a partnership agreement. The Certificate must be filed in the Office of the Secretary of State and the filing fee is $70.00. In addition, an out of state limited partnership must file an Application for Registration (LP-5) which must be signed by a general partner. The filing fee for this application is also $70.00.

Because prior to July 1, 1984 the limited partnership filed with the County rather than with the State, a frequently asked question is if the limited partnership was formed prior to July 1, 1984 how is the limited partnership canceled (so that it will no longer be subject to the $800 minimum franchise tax)? If the limited partnership was never registered with Secretary of State then it is canceled by filing a copy of the Certificate of Cancellation (LP-4/7) certified by the Secretary of State=s office with the county where the limited partnership was registered. In order to cancel the limited partnership at the state level, the entity must be on record with Secretary of State. To be on record at the state level, the limited partnership needs to file a Certificate of Limited Partnership (LP-1) or Application for Registration (LP-5) with the Secretary of State and then cancel and dissolve the limited partnership with the Secretary of State.

8 Limited Liability Partnerships

The LLP is formed by filing a registration statement with the Secretary of State=s office. (Registered Limited Liability Partnership Registration Form [LLP1]) The filing fee is $70.00. The registration statement must be executed by one or more of the partners. The LLP must include the words Limited Liability Partnership or LLP in its name to designate its status. Foreign LLPs must also register before transacting intrastate business and must also meet the requirements of the State Bar Association or the Board of Accountancy.[8]

[8] Cal Corp Code 15055(a).

To qualify, each of the partners of the LLP must qualify as a Alicensed person@ to practice law, accounting or architecture in California, or a person licensed or authorized to provide professional limited liability partnership services in a jurisdiction outside California. The definition of licensed persons covers persons who, although not licensed under the California Business and Professions Code, are nevertheless lawfully able to render professional limited liability partnership services in California because they are licensed in another state. The LLP form is also allowed for partnerships that provide services related or complementary to the professional limited liability partnership services provided by the architect, accounting or law firm.[9] This clause was included to allow the consulting businesses of accounting firms to also form LLPs. To be a related LLP, a majority of the licensed partners in one partnership must be partners in the other.

Foreign LLPs (i.e., LLPs formed under the laws of another jurisdiction) will be recognized in California, and will be governed by the laws of the jurisdiction where they were formed.[10] If a foreign LLP is allowed to engage in businesses other than accounting, architecture and law, it is uncertain whether the limited liability shield of California=s LLP statute would extend to cover transactions related to these businesses. California does require that foreign LLPs meet the insurance requirements and the tax filing/payment requirements set forth herein.

Foreign LLPs transacting business in California which are not registered in the state cannot maintain any proceeding in any court in the state. In addition, the LLP will be assessed a fine of $20 per day that unauthorized intrastate business is transacted up to a maximum of $10,000.[11] Transacting business is defined in the act but does not include activities that are typically excluded for corporations such as soliciting sales, holding meetings, maintaining bank accounts, and defending themselves in various legal proceedings. Activities in excess of these de minimis contacts would constitute doing business in the State.

In California, the LLP form was initially only available for law partnerships and accounting partnerships and, primarily to accommodate the consulting businesses of accounting firms, certain related partnerships. AB 469 (Cardoza), approved by Governor on 9/15/1998, allows architects to form limited liability partnerships.

One of the arguments against providing limited liability for professional service businesses is that tort liability insures a level of competence and review procedures to reduce the risk. Without the threat of malpractice claims, the level of professional competence will decline and the injured party will have no means of recovery, particularly if the reduced risk of limited liability results in under insuring. One way to respond to these criticisms,

9 Cal. Corp. Code 15002(I).

10 Cal. Corp. Code 15002(j).

11 Cal Corp Code 15055(I).

is to establish a level of minimum insurance. This is the approach taken by California.

The insurance requirement has been modified by SB 1080 (Calderon) which becomes effective on January 1, 1998.

Insurance requirement after January 1, 1998. Accounting Firms. For accounting firms the bill requires that LLPs with less than five licensed persons maintain at least $500,000 of liability insurance. Additionally, no partnership is required to maintain more than $5,000,000 of insurance regardless of size. The bill clarifies that the accounting firm will not be required to procure additional insurance if the settlement or defense of claims exhausts the coverage under the policy during the policy period. The policy period will be the period designated in the policy as long as that period does not extend for more than 12 months. The bill also provides that the policy may be subject to a deductible or self-insured retention as long as the amount is commercially reasonable. The bill also requires that if the partnership dissolves and winds up, then the minimum insurance required at that time must be retained for three years. In addition, the bill provides that accounting firms (like law firms) can meet the security requirement if each partner of a domestic or foreign LLP automatically guarantees payment of the difference between the maximum amount of security required for the partnership and the security otherwise provided.

Law Firms. For law firms the bill requires that LLPs with less than five licensed persons maintain at least $500,000 of liability insurance. Additionally, no partnership is required to maintain more than $7,500,000 of insurance regardless of size. The bill clarifies that the law firm will not be required to procure additional insurance if the settlement or defense of claims exhausts the coverage under the policy during the policy period. The policy period will be the period designated in the policy as long as that period does not extend for more than 12 months. The bill also provides that the policy may be subject to a deductible or self-insured retention as long as the amount is commercially reasonable. The bill also requires that if the partnership dissolves and winds up, then the minimum insurance required at that time must be retained for three years. In addition, the bill provides that each partner of a domestic or foreign LLP automatically guarantees payment of the difference between the maximum amount of security required for the partnership and the security otherwise provided.

Law firms now have an option of meeting the minimum insurance requirement through annual confirmation to the Secretary of State=s Office that the firm maintained a net worth of $15 million or more at the beginning of the year.[12]

LLPs in effect on January 1, 1997 can elect to be governed by the old insurance requirements (in other words the law prior to January 1, 1998 and described above). Such election can remain in effect until January 1, 1999 when the election expires and the LLP would be governed by the procedures effective for years beginning after January 1, 1998 and described above.

Architects. These LLP=s would be required to maintain liability insurance of at least $500,000 or an amount equal to $100,000 times the number of licensees in the firm , whichever is greater. Up to a maximum of $5 million, for claims arising from acts, errors or omissions arising out of the practice of architecture. In lieu of the insurance coverage , the LLP may maintain in trust or back escrow, cash, bank certificates of deposits, US Treasury obligations, or bank letters of credit in the required amount as security for payment of tort or contract

[12] Cal Corp Code 15052(a)(1)(C).

liabilities.

9 Corporations.

When the client incorporates they create a separate person under the law that has a separate existence from its owners. Its independent existence continues despite changeovers management or ownership. The corporation and not its shareholders is responsible for its debts. Its ownership interests can be freely traded and it is taxed as an independent entity.

In most cases the directors and officers and shareholders are not liable for debts owed by the corporation. Problem areas can be avoided if the following common sense principles are followed.

Personal guarantees. If the officer or shareholder guarantees personally a bank loan then there is no limited liability with respect to that obligation.

Taxes. If a corporation fails to pay income or payroll taxes, and IRS, FTB and EDD may assess taxes against a responsible person, or in the case of a fraudulent transfer, against the person who received the distribution.

Corporate Procedures. Certain requirements under state law must be met in order for the corporations separate existence to be respected. These procedures include issuing shares of stock, holding shareholder and board meetings, and recording management decisions in the corporate minutes.

Certain professions are not allowed to form a business corporation but are allowed to form a professional corporation. This is because the corporate entity should not come between the special relationship between the professional and person receiving the services. The following is a list of professionals that fall into this category:

Accountant
Acupuncturist
Architect
Attorney
Audiologist
Chiropractor
Clinical Social Worker
Dentist
Doctor
Marriage Counselor
Nurse
Optometrist
Osteopath
Pharmacist

Physical Therapist
Physicians Assistant
Podiatrist
Psychologist
Shorthand Reporter
Speech Pathologist
Veterinarian

If a professional practice of this type is incorporated, it must form a special type of corporation called a professional corporation. The professional corporation does not provide limited liability for the malpractice of the professional. and the malpractice of other professionals in the firm under their supervision. The limited liability is offered for business debts unrelated to malpractice.

A California for profit corporation with 35 or fewer shareholders may, by including close corporation provisions in its Articles of Incorporation and in its stock certificates, elect to be organized as a California close corporation. This type of corporation (frequently referred to as a statutory close corporation) is formed to provide for less formal management of the corporation and generally allows a partnership type structure. Close corporations are allowed by agreement to dispense with the need for annual director or shareholder meetings, election of corporate officers or election of a board of directors. It can distribute profits by agreement rather than by ownership. Although this may sound like a remedy to many problems encountered by small corporations, it is not. Frequently these types of corporations have restrictions on the transferability of their stock, an attribute of corporate ownership sought by many shareholders.

10 S Corporations.

The S Corporation is a creation of the tax law that allows the corporate entity to be taxed on a flow through basis. It is elected by filing a Form 2553 with the IRS within certain time frames and under certain requirements. The S Corporation cannot have more than 75 shareholders, all of which must be U. S. citizens or residents. The S Corporation must also meet certain other technical requirements. The S Corporation does not pay tax and flows through its earnings to its shareholders based on their ownership. In California, the S Corporation does pay tax at a rate of 1.5% (lower than the maximum corporate rate of 8.84%).

If the client wants to incorporate, it generally makes most sense to do so in California if the business is going to operate in the state. If the client goes out of state, the business will still have to qualify to do business and pay tax on the business conducted within the state, so for the small start up going out of state rarely makes sense. The more lenient corporate law of a state like Delaware refers to provisions of state law that will help a corporation fend off a corporate raider - a benefit for a large corporation but rarely of interest to a small locally operated entity.

11 Comparison of Tax Attributes

This section compares the various entity forms discussed above considering primarily the tax benefits of each available entity form. Its focus is primarily the LLC, the new entity form allowed in California since 1994.

Advantages of LLCs over C Corporation.

$ **Double Tax**. C Corporations pay an entity level federal and state income tax. The distributed income of a C corporation may be taxed twice as the shareholder is also taxed on dividends received from the C corporation. Perhaps the biggest benefit of the LLC over the C corporation is that the LLC is subject to one level of tax which is paid by the members of the LLC.

$ **Basis Adjustment**. A C corporation cannot adjust the tax basis of its assets in connection with a transfer of its shares. If the LLC makes an IRC 754 election then the LLC can adjust the tax basis of its assets in connection with transfers of membership interests. If the LLC is holding assets with a fair market value in excess of basis, the availability of such an adjustment may be valuable and may help the transferring member to obtain a higher price for his interest.

In addition, the basis of the member=s interest in an LLC and the S corporation are increased by the corporation=s profits (or reduced by losses). The basis of the C corporation shareholder in his stock investment is not affected by the profits of the corporation which means upon sale the C corporation shareholder will pay tax on the value of earnings retained in the C corporation.

$ **Special Allocations**. A C corporation may not specially allocate income or loss to its shareholders. An LLC, because it is treated as a partnership for income tax purposes, may specially allocate income or loss within the provisions of IRC 704(b).

$ Contributions. Corporations cannot receive tax-free contributions of property unless, immediately after the contribution, the contributor (alone or with others making contributions in related transactions) holds at least 80% of the total combined voting power of all classes of stock entitled to vote and at least 80% of the total number of shares of all other classes of stock of the corporation. LLCs generally can receive tax-free contributions of property from any member.

$ Liquidation. A C corporation is subject to a double tax on liquidation. An LLC generally can be liquidated without triggering any adverse tax consequences to the members.

$ Other Taxes. C corporations may be subject to an accumulated earnings tax or a personal holding company tax. These taxes are not imposed on an LLC.

$ Unreasonable Compensation. C corporations often run the risk of having shareholder salaries characterized as Aunreasonable compensation@ and disallowed. The unfortunate consequence of this result is that the payment is taxed as a dividend. The LLC does not run such a risk as it is generally irrelevant to the Service whether the member takes the payment as salary or distributive share of the LLC income under IRC 701.

$ **Receipt of LLC interest for profits interest**. Stock for Services is always taxable under IRC

83; receipt of an interest in an LLC for a profits interest is generally not taxable under Rev. Proc. 93-27 (1993-2 CB 343).

$ **Other non tax advantages include the following**:

E LLCs may provide members with unique economic, voting and other rights without creating a second class of stock.

E Rights of shareholders can be modified by amending the LLCs operating agreement which is not publicly filed.

E LLC managers can be elected according to the procedure set forth in the operating agreement. C corporations must generally allow their shareholder to use cumulative voting in the election of directors. Cumulative voting is designed to allow minority shareholder interests to obtain board representation.

E LLC members are not susceptible to a piercing the corporate veil attack solely as a consequence of the members= failure to satisfy certain administrative formalities such as annual meetings and election of Board of Directors.

Advantages of LLCs over S Corporations.

The S corporation operates under many restrictions which are not applicable to LLCs. These restrictions include the following:

$ **Number of members**. S corporations are limited to 75 shareholders. There are no restrictions on who may be a member of an LLC or on the number of members.

$ **Single class of stock**. S corporations are limited to a single class of stock. LLCs can have multiple classes of stock outstanding and an infinite variety of interests.

$ **Nonresident aliens**. S corporations cannot have a shareholder who is a nonresident alien individual. LLCs can have nonresident alien members.

$ **Basis adjustments**. S corporations shareholders cannot include indebtedness of the S corporation in basis. The tax basis of an LLC membership interest includes the member=s share of the entity=s indebtedness which may shelter from current gain recognition any operating distributions of cash.

$ **IRC 754 election**. S corporations cannot make an IRC 754 election to increase the tax basis of its assets in connection with a transfer of its shares. On the death of a shareholder or sale of stock an LLC can elect to adjust the basis of its assets.

$ **Entity level income tax**. S corporations which are doing business in California must pay a 1.5% net income tax. LLCs are not subject to this tax, but must pay an entity level fee based on gross receipts. If the business operates at a loss, the S corporation form is generally preferable. If the entity operates at a profit, then the LLC will generally result in the lesser tax liability.

Advantages of LLCs over limited partnerships.

Limited partnerships must have at least one general partner that is subject to unlimited liability. LLCs are not required to have a general partner. In addition, limited partners who participate in the management of the limited partnership can be classified as general partners and lose the benefit of limited liability. All members of an LLC can fully participate in management without jeopardizing their protection from such liability.

Advantages of LLCs over general partnerships.

LLC members are not personally liable for the debts and obligations of the entity. LLCs can restrict management powers to a subset of the members or to nonmember managers. General partners are fully liable for the debts of the partnership. Management of a general partnership is vested in the general partners who act in a fiduciary capacity vis a vis the partnership.

Advantages of LLCs over sole proprietorships.

An LLC limits the liability of the owners more than the liability can be limited in a sole proprietorship. Additionally an LLC can take in an investor without giving up control of the business.

Disadvantages of the LLC.

There are still uncertainties with respect to the operation and taxability of the LLC. The primary unresolved issue under federal law is whether members of the LLC have to pay the self employment tax on distributions. In addition, the fee assessed on gross receipts of the LLC under California law is extremely volatile. In 1999 the fee was increased by 73% and in 200 by another 20.5%. Each year after 1999, the FTB will conduct an analysis of the revenue loss to the state by allowing the LLC form. The fee will be adjusted accordingly. There is no limitation on the amount of the fee adjustment.

The LLC statute severely restricts the types of businesses that may elect to form as LLCs. Legislation which would have provided some relief did not pass. Limited Liability Partnerships legislation for attorneys, architects and accountants did pass and the provisions are discussed herein.

Managers who are actively involved in the management of the LLC will be subject to self-employment tax. Additionally, inactive LLC members will be treated as managers and their distributive share of the LLC=s income will be subject to self-employment tax if the LLC does not designate managers to operate the business.

The nontaxable fringe benefits available to LLC members are the same as those available to partners in a partnership. Therefore, LLCs are not afforded any of the exclusions for cafeteria plan benefits under IRC 125. In addition, LLCs cannot issue equity interests or options to acquire equity interests that qualify for tax-preferred treatment under the rules applicable to corporate incentive stock option and employee stock purchase plans.

$ Under IRC 741, the loss from the sale or exchange of an interest in an LLC is a capital loss. Under IRC 1244, shareholders of C corporations and C corporations generally may deduct a loss from the sale or exchange of their stock as ordinary loss if it qualifies as Section 1244 stock. The maximum amount that can be treated as an ordinary loss for any taxable year cannot exceed $50, 000 ($100,000 on joint returns).

$ Under IRC 1202, a noncorporate shareholder may exclude 50% of the gain from the sale or exchange of Aqualified small business stock@ held for more than 5 years, within certain dollar limits ($10,000,000). Such stock is generally C corporation stock issued after August 10, 1993. The 50% exclusion does not apply to LLC interests.

$ The self-employment and Medicare tax do not apply to the S corporation, even if the shareholder is active in the business, provided that the shareholder receives reasonable compensation for services rendered. It is not clear how LLC members will be treated for self-employment tax purposes. It is likely that those who are active in the business of the LLC will be treated as general partners and all of their distributive share of self employment income will be subject to the self-employment and Medicare tax.

$ LLCs must generally have the same tax year as the members of the LLC. Therefore, in most cases the LLC will be restricted to a calendar year.

$ Nonresident members of the LLC will be taxed on their California source income, while nonresident shareholders in a C corporation are not taxed by California on dividend distributions.

$ LLCs are required to pay the $800 minimum franchise tax plus a fee which is based on gross receipts. If the LLC operates at a loss then the payment to California will be greater than the payment required from an S corporation which pays a 1.5% income tax or the $800 minimum tax imposed on limited partnerships. Although the fee is deductible, it is not creditable against other states= income taxes for foreign LLCs doing business in California. LLCs can be formed only by compliance with legal formalities such as filing with the Secretary of State=s Office. A partnership can be formed with virtually no formalities, i.e., on a handshake.